TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE "AMERICAN WORKERS, STATE AND BUSINESS RELIEF ACT OF 2010," AS PASSED BY THE SENATE ON MARCH 10, 2010

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions contained in the "American Workers, State and Business Relief Act of 2010," as passed by the Senate on March 10, 2010. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

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[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the "American Workers, State and Business Relief Tax Act of 2010," as passed by the Senate on March 10, 2010,* (JCX-11-10), March 11, 2010. This document can also be found on our website at www.jct.gov.

TITLE I − EXTENSION OF EXPIRING PROVISIONS

A. Energy

1. Alternative motor vehicle credit for heavy hybrids (sec. 101 of the bill and sec. 30B of the Code)

Present Law

In general

A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year.[2] In general, the credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005. The credit terminates after 2009, 2010, or 2014, depending on the type of vehicle.

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

Hybrid vehicles

Qualified hybrid vehicles

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

Hybrid vehicles that are automobiles and light trucks

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard (the "base fuel economy") and (2) a conservation credit based on the

[2] Sec. 30B.

estimated lifetime fuel savings of the qualified vehicle compared to a comparable 2002 model year vehicle that is powered solely by a gasoline or diesel internal combustion engine. A qualified hybrid automobile or light truck must have a maximum available power[3] from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain Environmental Protection Agency ("EPA") emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less, the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 1, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of the base fuel economy.

Table 1.–Fuel Economy Credit

	If Fuel Economy of the Hybrid Vehicle Is:	
Credit	at least	but less than
$400	125% of base fuel economy	150% of base fuel economy
$800	150% of base fuel economy	175% of base fuel economy
$1,200	175% of base fuel economy	200% of base fuel economy
$1,600	200% of base fuel economy	225% of base fuel economy
$2,000	225% of base fuel economy	250% of base fuel economy
$2,400	250% of base fuel economy	

Table 2, below, shows the conservation credit.

Table 2.–Conservation Credit

Estimated Lifetime Fuel Savings (gallons of gasoline)	Conservation Amount
At least 1,200 but less than 1,800	$250
At least 1,800 but less than 2,400	$500
At least 2,400 but less than 3,000	$750
At least 3,000	$1,000

[3] For hybrid passenger vehicles and light trucks, the term "maximum available power" means the maximum power available from the rechargeable energy storage system, during a standard 10 second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine. Sec. 30B(d)(3)(C)(i).

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

There is a limitation on the number of passenger and light truck qualified hybrid vehicles and advanced lean burn technology vehicles[4] sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean burn technology vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

Thus, for example, summing the sales of qualified hybrid vehicles that are passenger vehicles or light trucks and all sales of qualified advanced lean burn technology vehicles, if a manufacturer records the sale of its 60,000th qualified vehicle in February of 2008, taxpayers purchasing such vehicles from the manufacturer may claim the full amount of the credit on their purchases of qualified vehicles through June 30, 2008. For the period July 1, 2008, through December 31, 2008, taxpayers may claim one half of the otherwise allowable credit on purchases of qualified vehicles of the manufacturer. For the period January 1, 2009, through June 30, 2009, taxpayers may claim one quarter of the otherwise allowable credit on the purchases of qualified vehicles of the manufacturer. After June 30, 2009, no credit may be claimed for purchases of such hybrid vehicles or advanced lean burn technology vehicles sold by the manufacturer.

Hybrid vehicles that are medium and heavy trucks

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

[4] A qualified advanced lean burn technology vehicle is a passenger automobile or a light truck that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and for 2004 and later model vehicles meets or exceeds certain Environmental Protection Agency emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. Sec. 30B(c)(3). A qualified advanced lean burn technology vehicle must be placed in service before January 1, 2011. Sec. 30B(k)(2).

increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

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

A qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualified hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.[5]

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy by vehicle type and vehicle inertia weight class. For this purpose, "vehicle inertia weight class" has the same meaning as when defined in regulations prescribed by the EPA for purposes of Title II of the Clean Air Act. Table 3, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

Table 3.–2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9

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

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Explanation of Provision

The provision extends for one year the credit available to hybrid vehicles that are medium and heavy trucks.

Effective Date

The provision is effective for property purchased after December 31, 2009.

2. Incentives for biodiesel and renewable diesel (sec. 102 of the bill and secs. 40A, 6426 and 6427 of the Code)

Present Law

Biodiesel

The Code provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[6] The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2009.

[6] Sec. 40A.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. sec. 7545) and (2) the requirements of the American Society of Testing and Materials ("ASTM") D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, camelina, or animal fats.

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

Biodiesel mixture credit

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

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture.[7] Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

Biodiesel credit (B-100)

The biodiesel credit is $1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

Small agri-biodiesel producer credit

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or,

[7] Notice 2005-62, I.R.B. 2005-35, 443 (2005). "A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture." Id.

(c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

<u>Biodiesel mixture excise tax credit</u>

The Code also provides an excise tax credit for biodiesel mixtures.[8] The credit is $1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[9]

The credit is not available for any sale or use for any period after December 31, 2009. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

<u>Payments with respect to biodiesel fuel mixtures</u>

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[10] The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2009.

<u>Renewable diesel</u>

"Renewable diesel" is liquid fuel that (1) is derived from biomass (as defined in section 45K(c)(3)), (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM for aviation turbine fuel.

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[8] Sec. 6426(c).

[9] Sec. 6426(c)(4).

[10] Sec. 6427(e).

For purposes of the Code, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[11] The incentive for renewable diesel is $1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2009.

Explanation of Provision

The provision extends the income tax credit, excise tax credit and payment provisions for biodiesel and renewable diesel for one additional year (through December 31, 2010).

Effective Date

The provision is effective for sales and uses after December 31, 2009.

3. Credit for electricity produced at certain open-loop biomass facilities (sec. 103 of the bill and sec. 45 of the Code)

Present Law

In general

An income tax credit is allowed for the production of electricity from biomass at qualified open-loop biomass facilities. The credit rate is 1.1 cents per kilowatt-hour of electricity produced in 2009 and is adjusted for inflation. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is a component of the general business credit, and excess credits may be carried back one year and forward up to 20 years.

Credit period

A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. However, for qualified open-loop biomass facilities (other than facilities described in section 45(d)(3)(A)(i) that use agricultural livestock waste nutrients) placed in service before October 22, 2004, the credit is available for a five-year period commencing on January 1, 2005.

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[11] Secs. 40A(f), 6426(c), and 6427(e).

Credit phase-out

The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. The electricity production credit is reduced over a 3-cent phase-out range to the extent the annual average contract price per kilowatt-hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation).

Open-loop biomass facility

An open-loop biomass facility is a facility that uses open-loop biomass to produce electricity. For purposes of the credit, open-loop biomass is defined as (1) any agricultural livestock waste nutrients or (2) any solid, nonhazardous, cellulosic waste material or any lignin material that is segregated from other waste materials and which is derived from:

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimmings; or
- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure. Wood waste materials do not qualify as open-loop biomass to the extent they are pressure treated, chemically treated, or painted. In addition, municipal solid waste, gas derived from the biodegradation of solid waste, and paper that is commonly recycled do not qualify as open-loop biomass. Open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2014, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2014. A qualified facility includes a new power generation unit placed in service after October 3, 2008, at an existing open-loop biomass facility, but only to the extent of the increased amount of electricity produced at the existing facility by reason of such new unit.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the credit available to qualified open-loop biomass facilities (other than facilities described in section 45(d)(3)(A)(i) that use agricultural livestock waste nutrients) placed in service before October 22, 2004.

Effective Date

The provision is effective for electricity produced and sold after December 31, 2009.

4. Credit for refined coal facilities (sec. 104 of the bill, Amendment 3371, and sec. 45 of the Code)

Present Law

In general

A credit is available for refined coal. In general, refined coal is a fuel produced from coal that is (1) used to produce steam or (2) used to produce steel industry fuel.

Refined coal used to produce steam

An income tax credit is allowed for the production at qualified facilities of certain refined coal sold to an unrelated person. The amount of the refined coal credit is $4.375 per ton (adjusted for inflation using 1992 as the base year). A taxpayer may generally claim the credit during the 10-year period commencing with the date the qualified facility is placed in service.

A qualifying refined coal facility is a facility producing refined coal that is placed in service after October 22, 2004, and before January 1, 2010. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that, when burned, emits 20 percent less nitrogen oxides and either sulfur dioxide or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, but only if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal, the taxpayer must sell the fuel with the reasonable expectation that it will be used for the primary purpose of producing steam.

The refined coal credit is reduced over an $8.75 phase-out range as the reference price of the fuel used as feedstock for the refined coal exceeds an amount equal to 1.7 times the reference price for such fuel in 2002 (adjusted for inflation). The amount of the credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit.

The credit is a component of the general business credit,[12] allowing excess credits to be carried back one year and forward up to 20 years. The credit is also subject to the alternative minimum tax.

[12] Sec. 38(b)(8).

<u>Facilities placed in service after 2008 that make refined coal used to produce steam</u>

For refined coal facilities placed in service after 2008, the requirement that the qualified refined coal fuel sell at a price at least 50 percent greater than the price of the feedstock coal does not apply. However, to be credit-eligible, refined coal produced by such facilities must reduce by 40 percent (not 20 percent) the amount by which refined coal must reduce, when burned, emissions of either sulfur dioxide or mercury compared to the emissions released by the feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003.

<u>Refined coal that is steel industry fuel</u>

Each barrel-of-oil equivalent (defined as 5.8 million British thermal units) of steel industry fuel produced at a qualified facility during the credit period receives a $2 credit (adjusted for inflation using 1992 as the base year). A qualified facility is any facility capable of producing steel industry fuel (or any modification to a facility making it so capable) that is placed in service before January 1, 2010. For facilities capable of producing steel industry fuel on or before October 1, 2008, the credit is available for fuel produced and sold on or after such date and before January 1, 2010. For facilities placed in service or modified to produce steel industry fuel after October 1, 2008, the credit period begins on the placed-in-service or modification date and ends one year after such date or December 31, 2009, whichever is later.

Steel industry fuel is defined as a fuel produced through a process of liquefying coal waste sludge, distributing the liquefied product on coal, and using the resulting mixture as a feedstock for the manufacture of coke. Coal waste sludge includes tar decanter sludge and related byproducts of the coking process.

<u>Explanation of Provision</u>

The provision extends for one year (through December 31, 2010) the placed-in-service period for new refined coal facilities. The provision also modifies the credit period for steel industry fuel. Under the provision, the credit period is changed to the two-year period beginning on the date that the facility first produces steel industry that is sold to an unrelated person after September 30, 2008.

The provision modifies the definition of steel industry fuel to include fuel produced through a process of distributing liquefied coal waste sludge on a blend of coal and petroleum coke, or on other coke feedstock.

The provision also clarifies that the owner of a facility producing steel industry fuel will be treated as producing and selling steel industry fuel where that owner manufactures such fuel from a feedstock to which it has title. With respect to such a facility, no person (including a ground lessor, customer, supplier, or technology licensor) will be treated as having an ownership interest in the facility or as otherwise entitled to the credit for the production of steel industry fuel if such person's rent, license fee, or other entitlement to net payments from the owner of such facility is measured by a fixed dollar amount or a fixed amount per ton, or otherwise determined without regard to the profit or loss of such facility. The sale of such steel industry fuel by the owner of the facility to a person who is not the owner of the facility does not fail to qualify as a sale to an unrelated person solely because the purchaser may also be a ground lessor, supplier, or customer.

Effective Date

The provision modifications to the placed-in-service period and the credit period are effective on the date of enactment. The other modifications are effective as if included in the amendments made by the Energy Improvement and Extension Act of 2008.[13]

5. Credit for production of low sulfur diesel fuel (sec. 105 of the bill and sec. 45H of the Code)

Present Law

Under present law, a small business refiner may claim a credit of five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements of the EPA. A small business refiner is a crude oil refiner that has no more than 1,500 individuals engaged in refinery operations on any given day and that had an average daily domestic refinery run or average retained production of not more than 205,000 barrels for the one-year period ending on December 31, 2002.

The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. The percentage limitation phases down pro rata for refiners that had runs in 2002 exceeding 155,000 barrels but less than 205,000 barrels.

Costs qualifying for the credit are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009. The taxpayer's basis in property with respect to which the credit applies is reduced by the amount of the production credit claimed.

Explanation of Provision

The provision extends the period for incurring qualifying costs for one additional year, through December 31, 2010.

Effective Date

The provision is effective as if included in section 339 of the American Jobs Creation Act of 2004.

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[13] Pub. L. No. 110-343.

6. Credit for producing fuel from coke or coke gas (sec. 106 of the bill and sec. 45K)

Present Law

Coke and coke gas produced in the United States at qualified facilities and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[14] per Btu barrel-of-oil equivalent (the "coke credit"). The credit is available for coke or coke gas produced during a four-year period beginning on the later of January 1, 2006, or the date the qualified facility was placed in service. For purposes of the coke credit, qualified facilities are facilities placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010. Qualified facilities do not include facilities that produce petroleum-based coke or coke gas. No credit is allowed with respect to coke produced from steel industry fuel if a credit is allowed for such fuel under section 45. 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 coke credit is part of the general business credit.

Explanation of Provision

The provision extends for one year the placed in service date for qualified facilities.

Effective Date

The proposal is effective for facilities placed in service after December 31, 2009.

7. New energy efficient home credit (sec. 107 of the bill and sec. 45L of the Code)

Present Law

The Code provides a credit to an eligible contractor for each qualified new energy-efficient home which is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible

[14] The inflation adjustment is calculated using 2004 as the base year.

contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

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

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes which are purchased prior to January 1, 2010. The credit is part of the general business credit.

Explanation of Provision

The provision extends the credit to homes which are purchased prior to January 1, 2011.

Effective Date

The provision applies to homes acquired after December 31, 2009.

8. Excise tax credits and outlay payments for alternative fuel (sec. 108 of the bill and secs. 6426 and 6427(e) of the Code)

Present Law

The Code provides two per-gallon excise tax credits with respect to alternative fuel, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process ("coal-to-liquids"), compressed or liquified gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after September 30, 2009 through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 50 percent of such facility's total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against section 4041 liability, and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents[15] of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An "alternative fuel mixture" is a mixture of alternative fuel and taxable fuel that contains at least 1/10 of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits generally expired after December 31, 2009 (September 30, 2014 for liquefied hydrogen).

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expired after December 31, 2009. With respect to liquefied hydrogen, the payment provisions expire after September 30, 2014. The alternative fuel credit and alternative fuel mixture credit must first be applied to excise tax liability for special and alternative fuels, and any excess credit may be taken as a payment.

Explanation of Provision

The provision extends the alternative fuel credit and payment provisions for one additional year (through December 31, 2010).

Effective Date

The provision is effective for fuel sold or used after December 31, 2009.

9. Special rule to implement FERC and State electric restructuring policy (sec. 109 of the bill and sec. 451(i) of the Code)

Present Law

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

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property

[15] "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

within the applicable period[16] (the "reinvestment property").[17] If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2010. A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both (1) a transmitting utility (as defined in the Federal Power Act) [18] with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act).[19]

In general, an independent transmission company is defined as: (1) an independent transmission provider[20] approved by the Federal Energy Regulatory Commission ("FERC"); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1). Exempt utility property does not include any property that is located outside of the United States.

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

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

[17] Sec. 451(i).

[18] Sec. 3(23), 16 U.S.C. 796, defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or Federal power marketing agency which owns or operates electric power transmission facilities which are used for the sale of electric energy at wholesale.

[19] Sec. 3(22), 16 U.S.C. 796, defines "electric utility" as any person or State agency (including any municipality) which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any Federal power marketing agency.

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

Explanation of Provision

The provision extends the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility prior to January 1, 2011.

Effective Date

The extension provision applies to transactions after December 31, 2009.

10. Suspension of limitation on percentage depletion for oil and gas from marginal wells (sec. 110 of the bill and sec. 613A of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[21] 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.[22] 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.[23] The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").[24] The 100-percent net-income limitation for marginal production has been suspended for taxable years beginning before January 1, 2010.

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

[21] Secs. 611-613.

[22] Sec. 613A.

[23] Sec. 613A(c).

[24] Sec. 613(a).

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).[25]

Description of Proposal

The proposal extends the suspension of the 100-percent net-income limitation for marginal production for one year (to apply to tax years beginning before January 1, 2011).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2009.

[25] The American Petroleum Institute gravity, or API gravity, is a measure of how heavy or light a petroleum liquid is compared to water.

B. Individual Tax Relief

1. Deduction for certain expenses of elementary and secondary school teachers (sec. 111 of the bill and sec. 62(a)(2)(D) of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally 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. With the exception of taxable years beginning in 2010, 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 a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2010, 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.[26] To be eligible for this deduction, the expenses must be otherwise deductible under section 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 twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that 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, 2009.

Explanation of Provision

The provision extends the deduction for eligible educator expenses for one year so that it is available for taxable years beginning before January 1, 2011.

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[26] Sec. 62(a)(2)(D).

Effective Date

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

2. Additional standard deduction for State and local real property taxes (sec. 112 of the bill and sec. 63 of the Code)

Present Law

In general

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. Unless an individual taxpayer elects, no itemized deduction is allowed for the taxable year. The deduction for certain taxes, including income taxes, real property taxes, and personal property taxes, generally is an itemized deduction.[27]

Special rule for State and local property taxes

An individual taxpayer's standard deduction for a taxable year beginning in 2009 is increased by the lesser of (1) the amount allowable[28] to the taxpayer as a deduction for State and local taxes described in section 164(a)(1) (relating to real property taxes), or (2) $500 ($1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under section 164 and, in the case of a tenant-stockholder in a cooperative housing corporation, real estate taxes for which a deduction is allowable to the taxpayer under section 216. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

Explanation of Provision

The provision extends the additional standard deduction for State and local property taxes for one year so that it is available for taxable years beginning before January 1, 2011.

Effective Date

The provision applies to taxable years beginning after December 31, 2009.

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[27] If the deduction for State and local taxes is attributable to business or rental income, the deduction is allowed in computing adjusted gross income and therefore is not an itemized deduction.

[28] In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as "allowable." See section 63(e).

3. Deduction for State and local general sales taxes (sec. 113 of the bill and sec. 164 of the Code)

Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004-2009, 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 that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

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

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

Explanation of Provision

The present-law provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for one year (through December 31, 2010).

Effective Date

The provision applies to taxable years beginning after December 31, 2009.

4. Contributions of capital gain real property made for conservation purposes (sec. 114 of the bill 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.[29]

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, (i.e., taxpayer's adjusted gross income computed without regard to any net operating loss carryback). The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section

[29] Secs. 170, 2055, and 2522, respectively.

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 as other charitable contributions of capital gain property.

Special rule regarding contributions of capital gain real property for conservation purposes

In general

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,[30] 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

[30] Sec. 170(b)(1)(E).

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 carry over 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 carry over 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

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.

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.[31]

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made on or before August 17, 2006.

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[31] Sec. 170(b)(2)(B).

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Termination

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2009.[32]

Explanation of Provision

The Act extends the special rule regarding contributions of capital gain real property for conservation purposes for one year for contributions made in taxable years beginning before January 1, 2011.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

5. Above-the-line deduction for qualified tuition and related expenses (sec. 115 of the bill and sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[33] The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes 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.[34] The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period 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.

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[32] Secs. 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

[33] Sec. 222.

[34] The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

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, 2009.

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,[35] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[36] 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 the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

Explanation of Provision

The provision extends the qualified tuition deduction for one year so that it is generally available for taxable years beginning before January 1, 2011.

Effective Date

The provision is effective for expenses incurred in taxable years beginning after December 31, 2009.

6. Tax-free distributions from individual retirement plans for charitable purposes (sec. 116 of the bill and sec. 408 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

[35] Secs. 222(d)(1) and 25A(g)(2).

[36] Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

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,[37] or to a Federal, State, or local governmental entity for exclusively public purposes.[38] 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.[39]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[40]

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.[41] 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.[42]

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[37] Secs. 170(c)(3)-(5).

[38] Sec. 170(c)(1).

[39] Secs. 170(b) and (e).

[40] Sec. 170(a).

[41] Sec. 170(f)(8). For any contribution of a cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. Sec. 170(f)(17).

[42] Sec. 6115.

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In 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.[43] 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.[44] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

<u>IRA rules</u>

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ 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 April 1 of the calendar year following the year in which the IRA owner attains age 70-½.[45]

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[43] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[44] Sec. 170(f)(2).

[45] Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

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;[46] (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.[47] Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

Qualified charitable distributions

Present law 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.[48] The exclusion may not exceed $100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable 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 qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described

[46] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[47] Sec. 3405.

[48] The exclusion does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2)). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the qualified charitable distribution 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 qualified charitable distribution provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under section 170.

The exclusion for qualified charitable distributions applies to distributions made in taxable years beginning after December 31, 2005. Under present law, the exclusion does not apply to distributions made in taxable years beginning after December 31, 2009.

Explanation of Provision

The provision extends the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009, and before January 1, 2011.

Effective Date

The provision is effective for distributions made in taxable years beginning after December 31, 2009.

7. Special rule for regulated investment company stock held in the estate of a nonresident non-citizen (sec. 117 of the bill and sec. 2105 of the Code)

Present Law

The gross estate of a decedent who was a U.S. citizen or resident generally includes all property – real, personal, tangible, and intangible – wherever situated.[49] The gross estate of a nonresident non-citizen decedent, by contrast, generally includes only property that at the time of the decedent's death is situated within the United States.[50] Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments, but does not include either bank deposits or portfolio obligations the interest on which would be exempt from U.S. income tax under section 871.[51] Stock owned and held by a nonresident non-citizen generally is treated as property within the United States if the stock was issued by a domestic corporation.[52]

Treaties may reduce U.S. taxation of transfers of the estates of nonresident non-citizens. Under recent treaties, for example, U.S. tax generally may be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a regulated investment company ("RIC") that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the "estate tax look-through rule for RIC stock").[53] This estate tax look-through rule for RIC stock does not apply to estates of decedents dying after December 31, 2009.

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[49] Sec. 2031. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA's rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

[50] Sec. 2103.

[51] Secs. 2104(c), 2105(b).

[52] Sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

[53] Sec. 2105(d).

Explanation of Provision

The provision permits the estate tax look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2011.[54]

Effective Date

The provision is effective for decedents dying after December 31, 2009.

8. Election for refundable low-income housing credit for 2010 and expansion of refundable tax credit for 2010 and grants in lieu of tax credits for 2009 to the GO Zone, Midwestern disaster area and Hurricane Ike disaster area (sec. 121 of the bill, Amendment 3374, and sec. 42 of the Code)

Present Law

Tax credits

In general

The low-income housing credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels.[55] The amount of the credit for any taxable year in the credit period is the "applicable percentage" of the qualified basis of each qualified low-income building. Generally, the applicable percentage is 70 percent for a new non-Federally subsidized building and 30 percent for all other buildings. Generally, a new building is considered Federally-subsidized if it also receives tax-exempt bond financing. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

Volume limits

Generally, a low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Each State has a limited amount of low-income housing credit available to allocate. This amount is called the aggregate housing credit dollar amount. The aggregate housing credit dollar amount for each State has four components: (1) the unused housing credit ceiling, if any, of such State from the prior calendar year; (2) the credit ceiling for the year; (3) any returns of credit ceiling to the State during the calendar year from previous allocations; and (4) the State's share, if any, of the national pool of unused credits from other States that failed to use them (only States which

[54] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA's rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

[55] Sec. 42.

allocated their entire credit ceiling for the preceding calendar year are eligible for a share of the national pool. For calendar year 2010, each State's credit ceiling is $2.10 per resident, with a minimum annual cap of $2,430,000 for certain small population States.[56] These amounts are indexed for inflation.

Certain buildings that also receive financing with proceeds of tax-exempt bonds do not require an allocation of the low-income housing credit. Generally, these buildings are buildings where 50 percent or more of the aggregate basis of the building and the land on which the building is located is financed with obligations tax-exempt under section 103 and subject to the private activity bond volume limits.[57]

Under special provisions, the otherwise applicable housing credit ceiling amount for certain years is increased for each of the States within the GO Zone, Midwestern disaster area, and Hurricane Ike disaster area, respectively. The GO Zone special allocation for each of three years (2006, 2007, and 2008) is $18.00 multiplied by the population of each State in the GO Zone. The Midwestern disaster area special allocation for each of three years (2008, 2009, and 2010) is $8.00 multiplied by the population of each State in the Midwestern disaster area. The Hurricane Ike disaster area special allocation for each of three years (2008, 2009, and 2010) is $16.00 multiplied by the number of residents within certain specified counties or parishes of the States of Texas and Louisiana.

Basic rule for Federal grants

The eligible basis of a qualified building must be reduced by the amount of any Federal grants with respect to such building.

Grants in lieu of tax credits for 2009

Low-income housing grant election amount

Under a special rule, the Secretary of the Treasury makes a grant to each State's housing credit agency in an amount equal to the low-income housing grant election amount for 2009.

The low-income housing grant election amount for a State is an amount elected by the State subject to certain limits. The maximum low-income housing grant election amount for a State may not exceed 85 percent of the product of ten (i.e., the length of the credit period) and the sum of the State's: (1) unused housing credit ceiling for 2008; (2) any returns to the State during 2009 of credit allocations previously made by the State; (3) 40 percent of the State's 2009 credit allocation; and (4) 40 percent of the State's share of the national pool allocated in 2009, if any.

These grants are not taxable income to recipients.

[56] Rev. Proc. 2009-50.

[57] sec. 146

Subawards to low-income housing credit buildings

A State receiving a grant under this election is to use these monies to make subawards to finance the construction or acquisition and rehabilitation of qualified low-income buildings as defined under the low-income housing credit. A subaward may be made to finance a qualified low-income building regardless of whether the building has an allocation of low-income housing credit. However, in the case of qualified low-income buildings without allocations of the low-income housing credit, the State housing credit agency must make a determination that the subaward with respect to such building will increase the total funds available to the State to build and rehabilitate affordable housing. In conjunction with this determination the State housing credit agency must establish a process in which applicants for the subawards must demonstrate good faith efforts to obtain investment commitments before the agency makes such subawards.

Any building receiving grant money from a subaward must satisfy the low-income housing credit rules. The State housing credit agency shall perform asset management functions to ensure compliance with the low-income housing credit rules and the long-term viability of buildings financed with these subawards.[58] Failure to satisfy the low-income housing credit rules will result in recapture enforced by means of liens or other methods that the Secretary (or delegate) deems appropriate. Any such recapture will be payable to the Secretary for deposit in the general fund of the Treasury.

Any grant funds not used to make subawards before January 1, 2011, and any grant monies from subawards returned on or after January 1, 2011, must be returned to the Secretary.

Basic rule for Federal grants

The grants received under the grant election do not reduce eligible basis of a qualified low-income building.

Reduction in low-income housing credit volume limit for 2009

The otherwise applicable component or components of the aggregate housing credit dollar amount for any State for 2009 are reduced by the amount taken into account in determining the low-income housing grant election amount.

Appropriations

Present law appropriates to the Secretary such sums as may be necessary to carry out this provision.

[58] The State housing credit agency may collect reasonable fees from subaward recipients to cover the expenses of the agency's asset management duties. Alternatively, the State housing credit agency may retain a third party to perform these asset management duties.

Explanation of Provision

Refundable tax credit

The provision creates a refundable tax credit for 2010 (rather than extends the 2009 election to substitute grants for nonrefundable tax credits). Specifically, the provision allows each State a refundable low -ncome housing tax credit to finance low-income buildings through grants to taxpayers. The amount of such refundable credit for each State shall equal the low-income housing refundable tax credit election amount. Each State's otherwise applicable low-income housing credit limits are reduced by the amount of the State's low-income housing refundable tax credit election amount.

For 2010 the maximum low-income housing refundable credit election amount for a State may not exceed 85 percent of the product of ten and the sum of the State's: (1) unused housing credit ceiling for 2009; (2) any returns to the State during 2010 of credit allocations previously made by the State; (3) 40 percent of the State's 2010 credit allocation; and (4) 40 percent of the State's share of the national pool allocated in 2010, if any.

Any refundable tax credits allowed under this provision not used to make grants before January 1, 2012 and any grant monies to taxpayers under this provision returned on or after January 1, 2012 must be returned to the Secretary.

The payments made under the provision do not reduce the tax basis of a qualified low-income building.

No change (other than with respect to the GO Zone, Midwestern Disaster area and the Hurricane Ike disaster area described below) is made to the operation of the 2009 election.

Special rule with respect to the GO Zone, Midwestern Disaster area and the Hurricane Ike disaster area

The provision expands both the refundable tax credit for 2010 and the grants in lieu of tax credits for 2009 with respect to the applicable special allocations for the GO Zone, Midwestern disaster area and the Hurricane Ike disaster area.

Effective Date

The provision related to the refundable low-income housing credit is effective on the date of enactment. The provision related to the low-income housing grant election is effective as if enacted in the American Recovery and Reinvestment Tax Act of 2009.[59]

[59] Pub. L. No. 111-5.

C. Business Tax Relief

1. Research credit (sec. 131 of the bill and sec. 41 of the Code)

Present Law

General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[60] Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is 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 is commonly referred to as the university basic research credit.[61]

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies 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, expires for amounts paid or incurred after December 31, 2009.[62]

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is 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 is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that

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[60] Sec. 41.

[61] Sec. 41(e).

[62] Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[63]

In computing the credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.[64] Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are 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.[65]

Alternative simplified credit

Taxpayers may elect to claim an alternative simplified credit for qualified research expenses. The alternative simplified research credit is equal to 14 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 six 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.

Eligible expenses

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the

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[63] 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) is 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 is 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. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is 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).

[64] Sec. 41(f)(1).

[65] Sec. 41(f)(3).

taxpayer's behalf (so-called contract research expenses).[66] Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[67] In addition, research does 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.[68] Research does not qualify for the credit if it is 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.[69] However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[70] Taxpayers

[66] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are 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 is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

[67] Sec. 41(d)(3).

[68] Sec. 41(d)(4).

[69] 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).

[70] Sec. 280C(c).

may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.[71]

Explanation of Provision

The provision extends the research credit for one year, through December 31, 2010.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2009.

2. Indian employment tax credit (sec. 132 of the bill and sec. 45A of the Code)

Present Law

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.[72] 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[73] or section 4(1) of the Indian Child Welfare Act of 1978.[74] 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

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[71] Sec. 280C(c)(3).

[72] Sec. 45A.

[73] Pub. L. No. 93-262.

[74] Pub. L. No. 95-608.

during the taxable year exceeds an amount determined at an annual rate of $30,000 (which after adjusted for inflation is currently $45,000 for 2009). 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 five 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 in taxable years that begin before January 1, 2010.

Explanation of Provision

The provision extends for one year the present-law employment credit provision (through taxable years beginning on or before December 31, 2010).

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

3. New markets tax credit (sec. 133 of the bill and sec. 45D of the Code)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE"). The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[75] Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

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

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[75] 12 U.S.C. 4702(17) (defines "low-income" for purposes of 12 U.S.C. 4702(20)).

The maximum annual amount of qualified equity investments is capped at $5 billion per year for calendar years 2008 and 2009.

Explanation of Provision

The provision extends the new markets tax credit for one year, through 2010, permitting up to $5 billion in qualified equity investments for that calendar year. The provision also extends for one year, through 2015, the carryover period for unused new markets tax credits.

Effective Date

The provision applies to calendar years beginning after 2009.

4. Railroad track maintenance credit (sec. 134 of the bill and sec. 45G of the Code)

Present Law

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during the taxable year.[76] The credit is limited to the product of $3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.[77] Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit may also reduce a taxpayer's tax liability below its tentative minimum tax.[78]

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).[79]

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.[80]

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[76] Sec. 45G(a).

[77] Sec. 45G(b)(1).

78 Sec. 38(c)(4).

[79] Sec. 45G(d).

[80] Sec. 45G(c).

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.[81]

The provision applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning before January 1, 2010.

Explanation of Provision

The provision extends the present law credit for one year, for qualified railroad track maintenance expenditures paid or incurred before January 1, 2011.

Effective Date

The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2009.

5. Mine rescue team training credit (sec. 135 of the bill and sec. 45N of the Code)

Present Law

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) $10,000. 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. The credit is not allowable for purposes of computing the alternative minimum tax.[82]

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. The term "wages" has the meaning given to such term by section 3306(b)[83] (determined without regard to any dollar limitation contained in that section).

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.[84] The credit does not apply to taxable years beginning after December 31, 2009.

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[81] Sec. 45G(e)(1).

[82] Sec. 38(c).

[83] Section 3306(b) defines wages for purposes of Federal Unemployment Tax.

[84] Sec. 280C(e).

Explanation of Provision

The provision extends the credit for one year through taxable years beginning on or before December 31, 2010.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

6. Employer wage credit for activated military reservists (sec. 136 of the bill and sec. 45P of the Code)

Present Law

Differential pay

In general, compensation paid by an employer to an employee is deductible by the employer under section 162(a)(1), unless the expense must be capitalized. In the case of an employee who is called to active duty with respect to the armed forces of the United States, some employers voluntarily pay the employee the difference between the compensation that the employer would have paid to the employee during the period of military service less the amount of pay received by the employee from the military. This payment by the employer is often referred to as "differential pay."

Wage credit for differential pay

If an employer qualifies as an eligible small business employer, the employer is allowed to take a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the employer's qualified employees for the taxable year.[85]

An eligible small business employer means, with respect to a taxable year, any taxpayer which: (1) employed on average less than 50 employees on business days during the taxable year; and (2) under a written plan of the taxpayer, provides eligible differential wage payments to every qualified employee of the taxpayer. Taxpayers under common control are aggregated for purposes of determining whether a taxpayer is an eligible small business employer. The credit is not available with respect to a taxpayer who has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the United States Code).

Differential wage payment means any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the

[85] Sec. 45P.

employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed $20,000. A qualified employee is an individual who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

No deduction may be taken for that portion of compensation which is equal to the credit. In addition, the amount of any other credit otherwise allowable under Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the Code with respect to compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee.

The differential wage payment credit is part of the general business credit, and thus this credit is subject to the rules applicable to business credits. For example, an unused credit generally may be carried back to the taxable year that precedes an unused credit year or carried forward to each of the 20 taxable years following the unused credit year. Any credit that is included in the general business credit, however, cannot be carried back to a tax year before the first tax year for which that credit is allowable under the effective date of that credit. Thus, the differential wage payment credit, if disallowed under section 38(c), cannot be carried back to tax years ending before June 18, 2008. In addition, unlike many of the other credits that are included in the general business credit, the differential wage payment credit is not a "qualified business credit" under section 196(c). Thus, a taxpayer cannot deduct under section 196(c) any differential wage payment credits that remain unused at the end of the 20-year carryforward period.

Rules similar to the rules in section 52(c), which bars the work opportunity tax credit for tax-exempt organizations other than certain farmer's cooperatives, apply to the differential wage payment credit. Additionally, rules similar to the rules in section 52(e), which limits the work opportunity tax credit allowable to regulated investment companies, real estate investment trusts, and certain cooperatives, apply to the differential wage payment credit.

The credit is not allowable against a taxpayer's alternative minimum tax liability. The amount of credit otherwise allowable under the income tax rules for compensation paid to any employee must be reduced by the differential wage payment credit with respect to that employee.

There are special rules for trusts and estates and their beneficiaries.

The credit is available with respect to amounts paid after June 17, 2008[86] and before January 1, 2010.

[86] This date is the date of enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110–245.

Explanation of Provision

The provision extends the availability of the credit to amounts paid before January 1, 2011.

Effective Date

The provision applies to payments made after December 31, 2009.

7. Certain farming business machinery and equipment treated as 5-year property (sec. 137 of the bill and sec. 168 of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS").[87] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[88] Asset class 01.1 includes machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agricultural, animal husbandry, and horticultural services. These assets are assigned a class life of 10 years and a recovery period of seven years.

However, Section 168(e)(3)(C)(vii) provides a statutory 5-year recovery period for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business and placed in service before January 1, 2010, and the original use of which commences with the taxpayer after December 31, 2008. For these purposes, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.[89] A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.[90]

Explanation of Provision

The provision extends the 5-year recovery period for one year to apply to property placed in service before January 1, 2011.

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[87] Sec. 168.

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

[89] Treas. Reg. sec. 1.263A-4(a)(4)(i).

[90] Treas. Reg. sec. 1.263A-4(a)(4)(ii).

Effective Date

The provision is effective for property placed in service after December 31, 2009.

8. 15-year straight-line cost recovery for qualified leasehold, restaurant, and retail improvement property and new restaurant buildings (sec. 138 of the bill and sec. 168 of the Code)

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[91] 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 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, 2010. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service after December 31, 2009 will be subject to the general rules described above.

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[91] Sec. 168.

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.

If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2010. Qualified restaurant property is any section 1250 property that is a building (if the building is placed in service before January 1, 2010) or an improvement to a building, if 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.[92] Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.[93] Restaurant property placed in service after December 31, 2009 will be subject to the general rules described above.

Qualified retail property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period and for qualified retail improvement property placed in service after December 31, 2008 and before January 1, 2010. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[94] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In the case of an improvement

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[92] Sec. 168(e)(7)((A).

[93] Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

[94] Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail property is not eligible for bonus depreciation.[95] Retail property placed in service in 2010 and later will be subject to the general rules described above.

Explanation of Provision

The present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are extended for to apply to property placed in service on or before December 31, 2010.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

9. Seven-year cost recovery period for motorsports entertainment complexes (sec. 139 of the bill and sec. 168 of the Code)

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[96] 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. Land improvements (such as roads

[95] Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

[96] Sec. 168.

and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service before December 31, 2009 is assigned a recovery period of seven years.[97] For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land that during the 36 month period following its placed-in-service date it hosts a racing event.[98] The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

Explanation of Provision

The provision extends the availability of the present law seven-year recovery period for motorsports entertainment complexes one year to apply to property placed in service before January 1, 2011.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

10. Accelerated depreciation for business property on Indian reservations (sec. 140 of the bill 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:

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

[97] Sec. 168(e)(3)(C)(ii).

[98] Sec. 168(i)(15).

"Qualified Indian reservation property" eligible for accelerated depreciation includes property described in the table above 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;[99] and (4) is not property placed in service for purposes of conducting gaming activities.[100] 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).[101]

An "Indian reservation" means a reservation as defined in section 3(d) of the Indian Financing Act of 1974[102] or section 4(10) of the Indian Child Welfare Act of 1978.[103] For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2010.

Explanation of Provision

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, 2010.

Effective Date

The provision is effective for property placed in service after December 31, 2009.

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[99] For these purposes, related persons is defined in Sec. 465(b)(3)(C).

[100] Sec. 168(j)(4)(A).

[101] Sec. 168(j)(4)(C).

[102] Pub. L. No. 93-262.

[103] Pub. L. No. 95-608.

11. Enhanced charitable deduction for contributions of food inventory (sec. 141 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions in general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

General rules regarding contributions of food inventory

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.[104] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.[105] 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.[106] In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.[107]

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[104] Sec. 170(e)(3).

[105] Sec. 170(b)(2).

[106] Sec. 170(e)(3)(A)(i)-(iii).

[107] Sec. 170(e)(3)(A)(iv).

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.[108] 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.[109]

Temporary rule expanding and modifying the enhanced deduction for contributions of food inventory

Under a special temporary 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.[110] 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, 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.[111]

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." Apparently wholesome food is defined as

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[108] Treas. Reg. sec. 1.170A-4A(c)(3).

[109] *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).

[110] Sec. 170(e)(3)(C).

[111] 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.

food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The temporary provision does not apply to contributions made after December 31, 2009.

Explanation of Provision

The proposal extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2011.

Effective Date

The proposal is effective for contributions made after December 31, 2009.

12. Enhanced charitable deduction for contributions of book inventories to public schools (sec. 142 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions in general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

General rules regarding contributions of book inventory

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.

In general, 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.[112] In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the

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[112] Sec. 170(e)(3).

corporation's taxable income.[113] 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.[114] In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.[115]

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.[116] 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.

Special rule expanding and modifying the enhanced deduction for contributions of book inventory

The generally applicable enhanced deduction for C corporations is expanded and modified to include certain qualified book contributions made after August 28, 2005, and before January 1, 2010.[117] 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 for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will (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

[113] Sec. 170(b)(2).

[114] Sec. 170(e)(3)(A)(i)-(iii).

[115] Sec. 170(e)(3)(A)(iv).

[116] Treas. Reg. sec. 1.170A-4A(c)(3).

[117] Sec. 170(e)(3)(D).

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.

Explanation of Provision

The provision extends the expansion of, and modifications to, the enhanced deduction for contributions of book inventory to contributions made before January 1, 2011.

Effective Date

The provision is effective for contributions made after December 31, 2009.

13. Enhanced charitable deduction for corporate contributions of computer technology and equipment for educational purposes (sec. 143 of the bill and sec. 170 of the Code)

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[118]

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."[119] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2009.[120]

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 or assembled the property, not later than the date construction or assembly of the property is substantially completed.[121] The original use of the property must be

[118] Sec. 170(e)(1).

[119] Secs. 170(e)(4) and 170(e)(6).

[120] Sec. 170(e)(6)(G).

[121] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

by the donor or the donee,[122] 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 or assembled by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[123]

Explanation of Provision

The provision extends the enhanced deduction for computer technology and equipment to contributions made during taxable years beginning after December 31, 2009, and before January 1, 2011.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 2009.

14. Election to expense mine safety equipment (sec. 144 of the bill and sec. 179E of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS").[124] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2009 is $250,000 of

[122] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[123] Sec. 170(e)(6)(C).

[124] Sec. 168.

the cost of the qualifying property for the taxable year.[125] For taxable years beginning in 2010, the limitation is $125,000. 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. For taxable years beginning in 2009, the $250,000 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 $800,000. The reduction amount is $500,000 for taxable years beginning in 2010. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning in 2010.

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.[126] "Qualified advanced mine safety equipment property" means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service before January 1, 2010.[127] This election does not apply for purposes of computing alternative minimum taxable income.[128]

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.[129]

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 under section 179E.[130] In addition, a taxpayer making an election under section 179E must file with the Secretary a report containing information with respect to the operation of the mines of the taxpayer as required by the Secretary.[131]

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[125] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A) and a renewal community (sec. 1400J).

[126] Sec. 179E(a).

[127] Secs. 179E(c) and (g).

[128] Sec. 56(g)(4)(C).

[129] Sec. 179E(d).

[130] Sec. 179E(e).

[131] Sec. 179E(f).

Explanation of Provision

The provision extends for one year, to December 31, 2010, the placed in service termination date for the present-law rule relating to expensing of mine safety equipment.

Effective Date

The provision applies to property placed in service after December 31, 2009.

15. Special expensing rules for certain film and television productions (sec. 145 of the bill and sec. 181 of the Code)

Present Law

The modified accelerated cost recovery system ("MACRS") does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property. 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, and patents are eligible to be recovered using the income forecast method of depreciation.

Under section 181, taxpayers may elect[132] to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2010, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[133] Taxpayers may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section.[134] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-

[132] See Treas. Reg. section 1.181-2T for rules on making an election under this section.

[133] For this purpose, a production is treated as commencing on the first date of principal photography.

[134] Sec. 181(a)(2)(A).

income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[135]

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[136] The term "compensation" does not include participations and residuals (as defined in section 167(g)(7)(B)).[137] With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision.[138] Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.[139]

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.[140]

Explanation of Provision

The provision extends the present law expensing provision for one year, to qualified film and television productions commencing prior to January 1, 2011.

Effective Date

The provision applies to qualified film and television productions commencing after December 31, 2009.

16. Expensing of environmental remediation costs (sec. 146 of the bill and sec. 198 of the Code)

Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[141] Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but

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[135] Sec. 181(a)(2)(B).

[136] Sec. 181(d)(3)(A).

[137] Sec. 181(d)(3)(B).

[138] Sec. 181(d)(2)(B).

[139] Sec. 181(d)(2)(C).

[140] Sec. 1245(a)(2)(C).

[141] Sec. 162.

keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense.[142] 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.[143] Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on all relevant facts and circumstances.

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.[144] 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 that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[145] 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")[146] cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

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

[142] Treas. Reg. sec. 1.162-4.

[143] Treas. Reg. sec. 1.263(a)-1(b).

[144] Sec. 198.

[145] 418 U.S. 1 (1974).

[146] Pub. L. No. 96-510 (1980).

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 section 198.

Section 1400N(g) permits the expensing of environmental remediation expenditures paid or incurred before January 1, 2010, to abate contamination at qualified contaminated sites located in the Gulf Opportunity Zone.

Explanation of Provision

The provision extends the present law expensing for one year to include expenditures paid or incurred before January 1, 2011.

Effective Date

The provision is effective for expenditures paid or incurred after December 31, 2009.

17. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 147 of the bill and sec. 199 of the Code)

Present Law

General

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[147] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film[148] produced by the taxpayer; (3) any

[147] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

[148] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[149] Wages paid to bona fide residents of Puerto Rico generally are not included in the definition of wages for purposes of computing the wage limitation amount.[150]

Rules for Puerto Rico

When used in the Code in a geographical sense, the term "United States" generally includes only the States and the District of Columbia.[151] A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term "United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations.[152] In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.[153]

The special rules for Puerto Rico apply only with respect to the first four taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2010.

Explanation of Provision

The provision allows the special domestic production activities rules for Puerto Rico to apply for the first five taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2011.

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[149] 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. .

[150] Section 3401(a)(8)(C) excludes wages paid to United States citizens who are bona fide residents of Puerto Rico from the term wages for purposes of income tax withholding.

[151] Sec. 7701(a)(9).

[152] Sec. 199(d)(8)(A).

[153] Sec. 199(d)(8)(B).

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

18. Modification of tax treatment of certain payments to controlling exempt organizations (sec. 148 of the bill and sec. 512 of the Code)

Present Law

In general, organizations exempt from Federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[154] In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.[155]

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, section 512(b)(13) 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 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). However, a special rule provides that, for payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length).[156] In addition, the special rule 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.

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).

The special rule does not apply to payments received or accrued after December 31, 2009.

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[154] Sec. 511.

[155] Sec. 512(b).

[156] Sec. 512(b)(13)(E).

Explanation of Provision

The provision extends the special rule to payments received or accrued before January 1, 2011. Accordingly, under the provision, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of section 482 (i.e., at arm's length). Any such excess is subject to 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.

Effective Date

The provision is effective for payments received or accrued after December 31, 2009.

19. Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income (sec. 149 of the bill and secs. 512 and 514 of the Code)

Present Law

Taxation of unrelated business income

In general, an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes. Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from "debt-financed property." Debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year.

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include: (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption; (2) obligations to pay certain types of annuities; (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons; or (4) indebtedness incurred by certain qualified organizations to acquire or improve real property.

Special rules apply in the case of an exempt organization that owns an interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

Special rules for certain qualifying brownfield properties

In general

Section 512(b)(19) provides a special exclusion from unrelated business taxable income for the gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property by an eligible taxpayer. The exclusion from unrelated business taxable income generally is available to an exempt organization that acquires, remediates, and disposes of the qualifying brownfield property. In addition, present law provides an exception from the debt-financed property rules for such properties.

To qualify for the exclusions from unrelated business income and the debt-financed property rules, the eligible taxpayer is required to: (a) acquire from an unrelated person real property that constitutes a qualifying brownfield property; (b) pay or incur a minimum level of eligible remediation expenditures with respect to the property; and (c) transfer the remediated site to an unrelated person in a transaction that constitutes a sale, exchange, or other disposition for purposes of Federal income tax law.[157]

The special exclusion applies only to gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009.[158]

Qualifying brownfield properties

The exclusion from unrelated business taxable income applies only to real property that constitutes a qualifying brownfield property. A qualifying brownfield property means real property that is certified, before the taxpayer incurs any eligible remediation expenditures (other than to obtain a Phase I environmental site assessment), by an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located as a brownfield site within the meaning of section 101(39) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") (as in effect on the date of enactment of the provision). The taxpayer's request for certification must include a sworn statement of the taxpayer and supporting documentation of the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property (including a Phase I environmental site assessment and, if applicable, evidence of the

[157] A person is related to another person if (1) such person bears a relationship to such other person that is described in section 267(b) (determined without regard to paragraph (9)), or section 707(b)(1), determined by substituting 25 percent for 50 percent each place it appears therein; or (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

[158] Sec. 512(b)(19)(K).

property's presence on a local, State, or Federal list of brownfields or contaminated property) and other environmental assessments prepared or obtained by the taxpayer.

Eligible taxpayer

An eligible taxpayer with respect to a qualifying brownfield property is an organization exempt from tax under section 501(a) that acquired such property from an unrelated person and paid or incurred a minimum amount of eligible remediation expenditures with respect to such property. The exempt organization (or the qualifying partnership of which it is a partner) is required to pay or incur eligible remediation expenditures with respect to a qualifying brownfield property in an amount that exceeds the greater of: (a) $550,000; or (b) 12 percent of the fair market value of the property at the time such property is acquired by the taxpayer, determined as if the property were not contaminated.

An eligible taxpayer does not include an organization that is: (1) potentially liable under section 107 of CERCLA with respect to the property; (2) affiliated with any other person that is potentially liable thereunder through any direct or indirect familial relationship or any contractual, corporate, or financial relationship (other than a contractual, corporate, or financial relationship that is created by the instruments by which title to a qualifying brownfield property is conveyed or financed by a contract of sale of goods or services); or (3) the result of a reorganization of a business entity which was so potentially liable.[159]

Qualified sale, exchange, or other disposition

A sale, exchange, or other disposition of a qualifying brownfield property is considered qualified if such property is transferred by the eligible taxpayer to an unrelated person, and within one year of such transfer the taxpayer has received a certification (a "remediation certification") from the Environmental Protection Agency or an appropriate State agency (within the meaning of section 198(c)(4)) in the State in which the property is located that, as a result of the taxpayer's remediation actions, such property would not be treated as a qualifying brownfield property in the hands of the transferee. A taxpayer's request for a remediation certification must be made no later than the date of the transfer and must include a sworn statement by the taxpayer certifying that: (1) remedial actions that comply with all applicable or relevant and appropriate requirements (consistent with section 121(d) of CERCLA) have been substantially completed, such that there are no hazardous substances, pollutants or contaminants that complicate the expansion, redevelopment, or reuse of the property given the property's reasonably anticipated future land uses or capacity for uses of the property; (2) the reasonably anticipated future land

[159] In general, a person is potentially liable under section 107 of CERCLA if: (1) it is the owner and operator of a vessel or a facility; (2) at the time of disposal of any hazardous substance it owned or operated any facility at which such hazardous substances were disposed of; (3) by contract, agreement, or otherwise it arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or incineration vessel owned or operated by another party or entity and containing such hazardous substances; or (4) it accepts or accepted any hazardous substances for transport to disposal or treatment facilities, incineration vessels or sites selected by such person, from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance. 42 U.S.C. sec. 9607(a) (2004).

uses or capacity for uses of the property are more economically productive or environmentally beneficial than the uses of the property in existence on the date the property was certified as a qualifying brownfield property;[160] (3) a remediation plan has been implemented to bring the property in compliance with all applicable local, State, and Federal environmental laws, regulations, and standards and to ensure that remediation protects human health and the environment; (4) the remediation plan, including any physical improvements required to remediate the property, is either complete or substantially complete, and if substantially complete,[161] sufficient monitoring, funding, institutional controls, and financial assurances have been put in place to ensure the complete remediation of the site in accordance with the remediation plan as soon as is reasonably practicable after the disposition of the property by the taxpayer; and (5) public notice and the opportunity for comment on the request for certification (in the same form and manner as required for public participation required under section 117(a) of CERCLA (as in effect on the date of enactment of the provision)) was completed before the date of such request. Public notice must include, at a minimum, publication in a major local newspaper of general circulation.

Eligible remediation expenditures

Eligible remediation expenditures means, with respect to any qualifying brownfield property: (1) expenditures that are paid or incurred by the taxpayer to an unrelated person to obtain a Phase I environmental site assessment of the property; (2) amounts paid or incurred by the taxpayer after receipt of the certification that the property is a qualifying brownfield property for goods and services necessary to obtain the remediation certification; and (3) expenditures to obtain remediation cost-cap or stop-loss coverage, re-opener or regulatory action coverage, or similar coverage under environmental insurance policies,[162] or to obtain financial guarantees required to manage the remediation and monitoring of the property. Eligible remediation expenditures include expenditures to: (1) manage, remove, control, contain, abate, or otherwise remediate a hazardous substance, pollutant, or contaminant on the property; (2) obtain a Phase II environmental site assessment of the property, including any expenditure to monitor, sample, study, assess, or otherwise evaluate the release, threat of release, or presence of a hazardous substance, pollutant, or contaminant on the property; or (3) obtain environmental regulatory certifications and approvals required to manage the remediation and monitoring of the hazardous substance, pollutant, or contaminant on the property. Eligible remediation expenditures do not include: (1) any portion of the purchase price paid or incurred by the eligible taxpayer to acquire the qualifying brownfield property; (2) environmental insurance costs paid or incurred to obtain legal defense coverage, owner/operator liability coverage, lender liability coverage, professional

[160] For this purpose, use of the property as a landfill or other hazardous waste facility shall not be considered more economically productive or environmentally beneficial.

[161] For these purposes, substantial completion means any necessary physical construction is complete, all immediate threats have been eliminated, and all long-term threats are under control.

[162] Cleanup cost-cap or stop-loss coverage is coverage that places an upper limit on the costs of cleanup that the insured may have to pay. Re-opener or regulatory action coverage is coverage for costs associated with any future government actions that require further site cleanup, including costs associated with the loss of use of site improvements.

liability coverage, or similar types of coverage;[163] (3) any amount paid or incurred to the extent such amount is reimbursed, funded or otherwise subsidized by: (a) grants provided by the United States, a State, or a political subdivision of a State for use in connection with the property; (b) proceeds of an issue of State or local government obligations used to provide financing for the property, the interest of which is exempt from tax under section 103; or (c) subsidized financing provided (directly or indirectly) under a Federal, State, or local program in connection with the property; or (4) any expenditure paid or incurred before the date of enactment of the provision.

Qualified gain or loss

Section 512(b)(19) generally excludes from unrelated business taxable income the exempt organization's gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property. Income, gain, or loss from other transfers does not qualify under the provision.[164] The amount of gain or loss excluded from unrelated business taxable income is not limited to or based upon the increase or decrease in value of the property that is attributable to the taxpayer's expenditure of eligible remediation expenditures. Further, the exclusion does not apply to an amount treated as gain that is ordinary income with respect to section 1245 or section 1250 property, including any amount deducted as a section 198 expense that is subject to the recapture rules of section 198(e), if the taxpayer had deducted such amount in the computation of its unrelated business taxable income.[165]

Special rules for qualifying partnerships

In the case of a tax-exempt organization that is a partner of a qualifying partnership that acquires, remediates, and disposes of a qualifying brownfield property, the provision applies to the tax-exempt partner's distributive share of the qualifying partnership's gain or loss from the disposition of the property.[166] A qualifying partnership is a partnership that: (1) has a partnership agreement that satisfies the requirements of section 514(c)(9)(B)(vi) at all times beginning on the date of the first certification received by the partnership that one of its

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[163] For this purpose, professional liability insurance is coverage for errors and omissions by public and private parties dealing with or managing contaminated land issues, and includes coverage under policies referred to as owner-controlled insurance. Owner/operator liability coverage is coverage for those parties that own the site or conduct business or engage in cleanup operations on the site. Legal defense coverage is coverage for lawsuits associated with liability claims against the insured made by enforcement agencies or third parties, including by private parties.

[164] For example, rent income from leasing the property does not qualify.

[165] Depreciation or section 198 amounts that the taxpayer had not used to determine its unrelated business taxable income are not treated as gain that is ordinary income under sections 1245 or 1250 (secs. 1.1245-2(a)(8) and 1.1250-2(d)(6)), and are not recognized as gain or ordinary income upon the sale, exchange, or disposition of the property. Thus, an exempt organization would not be entitled to a double benefit resulting from a section 198 expense deduction and the proposed exclusion from gain with respect to any amounts it deducts under section 198.

[166] The exclusions do not apply to a tax-exempt partner's gain or loss from the tax-exempt partner's sale, exchange, or other disposition of its partnership interest. Such transactions continue to be governed by prior law.

properties is a qualifying brownfield property; (2) satisfies the requirements of the proposal if such requirements are applied to the partnership (rather than to the eligible taxpayer that is a partner of the partnership); and (3) is not an organization that would be prevented from constituting an eligible taxpayer by reason of it or an affiliate being potentially liable under CERCLA with respect to the property.

The exclusion is available to a tax-exempt organization with respect to a particular property acquired, remediated, and disposed of by a qualifying partnership only if the exempt organization is a partner of the partnership at all times during the period beginning on the date of the first certification received by the partnership that one of its properties is a qualifying brownfield property, and ending on the date of the disposition of the property by the partnership.

If the property is acquired and remediated by a qualifying partnership of which the exempt organization is a partner, it is intended that the certification as to status as a qualified brownfield property and the remediation certification will be obtained by the qualifying partnership, rather than by the tax-exempt partner, and that both the eligible taxpayer and the qualifying partnership will be required to make available such copies of the certifications to the IRS. Any elections or revocations regarding the application of the eligible remediation expenditure rules to multiple properties (as described below) acquired, remediated, and disposed of by a qualifying partnership must be made by the partnership. A tax-exempt partner is bound by an election made by the qualifying partnership of which it is a partner.

Special rules for multiple properties

The eligible remediation expenditure determinations generally are made on a property-by-property basis. An exempt organization (or a qualifying partnership of which the exempt organization is a partner) that acquires, remediates, and disposes of multiple qualifying brownfield properties, however, may elect to make the eligible remediation expenditure determinations on a multiple-property basis. In the case of such an election, the taxpayer satisfies the eligible remediation expenditures test with respect to all qualifying brownfield properties acquired during the election period if the average of the eligible remediation expenditures for all such properties exceeds the greater of: (a) $550,000; or (b) 12 percent of the average of the fair market value of the properties, determined as of the dates they were acquired by the taxpayer and as if they were not contaminated. If the eligible taxpayer elects to make the eligible remediation expenditure determination on a multiple property basis, then the election shall apply to all qualifying sales, exchanges, or other dispositions of qualifying brownfield properties the acquisition and transfer of which occur during the period for which the election remains in effect.[167]

Debt-financed property

The present law provision provides that debt-financed property, as defined by section 514(b), does not include any property the gain or loss from the sale, exchange, or other

[167] If the taxpayer fails to satisfy the averaging test for the properties subject to the election, then the taxpayer may not apply the exclusion on a separate property basis with respect to any of such properties.

disposition of which is excluded by reason of the provisions of the proposal that exclude such gain or loss from computing the gross income of any unrelated trade or business of the taxpayer. Thus, gain or loss from the sale, exchange, or other disposition of a qualifying brownfield property that otherwise satisfies the requirements of the provision is not taxed as unrelated business taxable income merely because the taxpayer incurred debt to acquire or improve the site.

Termination date

As noted above, only gain or loss on the sale, exchange, or other disposition of property that is acquired by the eligible taxpayer or qualifying partnership during the period beginning January 1, 2005, and ending December 31, 2009, is eligible for the special exclusion. Property acquired during the five-year acquisition period need not be disposed of by the termination date in order to qualify for the exclusion. For purposes of the multiple property election, gain or loss on property acquired after December 31, 2009, is not eligible for the exclusion from unrelated business taxable income, although properties acquired after the termination date (but during the election period) are included for purposes of determining average eligible remediation expenditures.

Explanation of Provision

The provision extends the special exclusion from unrelated business taxable income to properties acquired by an eligible taxpayer or qualifying partnership before January 1, 2011.

Effective Date

The provision is effective for property acquired after December 31, 2009.

20. Real estate investment trust timber provisions (sec. 150 of the bill and secs. 856 and 857 of the Code)

Present Law

Real estate investment trusts

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[168] the REIT must derive most of its income from passive, generally real estate related investments; and REIT assets must be primarily real estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and

[168] Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met to avoid an excise tax under section 4981.

no more than 50 percent of the REIT interests may be owned by 5 or fewer individual shareholders (as determined using specified attribution rules). A REIT must generally have a calendar year annual accounting period.[169] Other requirements also apply.[170]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[171]

Certain income tests

A REIT generally is restricted to earning certain types of passive income. Among other requirements, at least 75 percent of the gross income of a REIT in a taxable year (the 75-percent income test) must consist of certain types of real estate related income, including rents from real property; income from the sale or exchange of real property (including interests in real property) that is not property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business);[172] interest on mortgages secured by real property or interests in real property; and certain amounts received or accrued for entering into contracts to make loans secured by mortgages on real property or interests in real property, or to purchase or lease real property (including interests in real property and interests in mortgages on real property).[173] In addition, at least 95 percent of REIT gross income (the 95-percent income test) must be derived from sources that include the 75-percent income test sources plus other sources including interest, dividends, or gain from the sale or other disposition of stock or securities that are not property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business).[174] Interests in real property are generally specifically defined to exclude mineral, oil, or gas royalty interests.[175] However, under

[169] Sec. 859. There is an exception for certain REITs in existence prior to October 4, 1976.

[170] Secs. 856 and 857.

[171] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[172] Sec. 856(c)(3)(C) and sec. 1221(a)(1). Gain from the sale of section 1221(a) (1) property is qualified income, however, if it is gain from the sale of a real estate asset which is not a prohibited transaction solely by reason of the prohibited transaction safe harbor of section 857(b)(6). See sec. 856(c)(3)(H).

[173] Section 856(c)(3).

[174] Sec. 856(c)(2)(D) and sec. 1221(a)(1). Gain from the sale of section 1221(a) (1) property is qualified income, however, if it is gain from the sale of a real estate asset which is not a prohibited transaction solely by reason of the prohibited transaction safe harbor of section 857(b)(6). See sec. 856(c)(2)(H).

[175] Section 856(c)(5)(C).

the Food, Conservation, and Energy Act of 2008,[176] for the first taxable year of a REIT beginning after May 22, 2008,[177] if the REIT is a "timber REIT" (defined as a REIT in which more than 50 percent of the value of its total assets consists of real property held in connection with the trade or business of producing timber), then mineral royalty income from real property owned by the timber REIT and held, or once held, in connection with the trade or business of producing timber by such REIT, is included as qualifying income for purposes of the REIT 95-percent income test (but not for purposes of the 75-percent income test).[178]

Certain asset tests

In addition to other asset tests, a REIT is not generally permitted to hold securities representing more than 10 percent of the voting power or value of the securities of any one issuer; nor may more than 5 percent of the fair market value of REIT assets be securities of any one issuer.[179] However, under an exception, a REIT may hold any amount of securities of one or more taxable REIT subsidiary ("TRS") corporations, provided that such TRS securities do not represent more than 25 percent of the fair market value of REIT assets at the end of any quarter.[180] A TRS is a C corporation that is subject to regular corporate tax on its income and that meets certain other requirements. A taxable REIT subsidiary may conduct activities that would produce disqualified non-passive or non-real estate income that could disqualify the REIT if conducted by a REIT itself. Such business could include business relating to processing timber, or holding timber products or other assets for sale to customers in the ordinary course of business. Such income would be subject to regular corporate rates of tax as income of the TRS.[181]

[176] H.R. 2419, Pub. L. No. 110-234, enacted on May 22, 2008 and reenacted in H.R. 6124, Pub. L. No. 110-246, to correct certain unrelated technical deficiencies, with the original effective date for the provisions discussed here.

[177] May 22, 2008 is the date of enactment of the Food, Conservation, and Energy Act of 2008. See immediately preceding footnote.

[178] Sections 856(c)(2)(I) and 856(c)(5)(I).

[179] Section 856(c)(4)(B)(iii). Certain interests are not treated as "securities" for purposes of the rule forbidding the REIT to hold securities representing more than 10 percent of the value of securities of any one issuer. Sec. 856(m).

[180] Sec. 856(c)(4)(B)(ii) and (iii). Prior to enactment of the Food, Conservation and Energy Act of 2008, the limit on REIT ownership of TRS securities was 20 percent of the fair market value of REIT assets. For timber REITs, that Act changed that 20-percent limit to 25-percent, in the case of periods closing before the last day of the first taxable year of the timber REIT beginning after May 22, 2008 and before May 22, 2009. The Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110- 289) applied the 25-percent limit to all REITs and made the provision permanent.

[181] A 100-percent excise tax is imposed on the amount of certain transactions involving a TRS and a REIT, to the extent such amount would exceed an arm's length amount under section 482. Sec. 857(b)(7).

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale for sale to customers in the ordinary course of its trade or business)" that is not foreclosure property.[182] The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in sections 857(b)(6)(C) (applicable to real estate assets generally) or 857(b)6)(D) (applicable to real estate assets held in connection with the trade or business of producing timber), including an asset holding period of at least 2 years.[183] If the conditions are met, a REIT may either (1) make no more than 7 sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell no more than 10 percent of the aggregate bases or fair market value of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.

Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property,[184] generally require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person. However, under the Food,

[182] Sec. 897(b)(6)(B)(iii). This type of income also is not qualified income for purposes of the 75-percent or 95-percent income tests, unless it is excluded from the PTT solely by reason of the safe harbors under section 857(b)(6)(C) or 857(b)(6)(D).

[183] Prior to enactment of the Food, Conservation, and Energy Act of 2008, the required holding period was 4 years. That Act reduced the holding period to 2 years, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, but only in the case of timber property under section 857(b)(6)(D) (not in the case of property under section 857(b)(6)(C)) and then only if that timber property were sold to a qualified conservation organization for qualified conservation purposes (as those terms are defined in section 170(h)(3) and 170(h)(1)(C), respectively). The Housing and Economic Recovery Act of 2008, (H.R. 3221, Pub. L. 110-289) reduced the holding period to 2 years on a permanent basis, for both sections 857(b)(6)(C) and 857(B)(6)(D), applicable to all REITs and without the requirement of a sale to a qualified conservation organization for qualified conservation purposes. The remaining impact of the Food, Conservation and Energy Act of 2008 PTT safe harbor provision, which expires at the end of the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, is the rule that if the sale qualifies for the 857(b)(6)(D) safe harbor (as in effect immediately prior to enactment of the Housing and Economic Recovery Act of 2008, as modified by the rule then in effect for property held at least 2 years and sold to a qualified conservation organization for qualified conservation purposes), then the sale is treated for all purposes of the Code as a sale of property held for investment or for use in a trade or business and not property described in section 1221(a)(1). See secs. 857(b)(6)(G) and 857(b)(6)(H).

[184] Prior to enactment of the Food, Conservation, and Energy Act of 2008, the required measurement period was 4 years. That Act reduced the holding period to 2 years, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, but only in the case of property held in connection with the trade or business of producing timber under section 857(b)(6)(D) (not in the case of property under section 857(b)(6)(C), and then only if such timber property were sold to a qualified conservation organization for qualified conservation purposes (as those terms are defined in section 170(h)(3) and 170(h)(1)(C), respectively). The Housing and Economic Recovery Act of 2008 reduced the measurement period to 2 years on a permanent basis, for both sections 857(b)(6)(C) and 857(B)(6)(D), applicable to all REITs and without the requirement of a sale to a qualified conservation organization for qualified conservation purposes.

Conservation, and Energy Act of 2008, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, for purposes of the timber property safe harbor under section 856(b)(6)(D), the marketing may be done by a taxable REIT subsidiary.[185]

For the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, in the case of a sale of property that is not a prohibited transaction through the application of section 857(b)(6)(D) (as in effect immediately prior to the enactment of the Housing and Economic Recovery Act of 2008, as modified by section 856(b)(6)(G) then in effect), the sale is treated as a sale of property held for investment or for use in a trade or business and not property described in section 1221(a)(1) for all purposes of the Code. Section 857(b)(6)(D) as so in effect at the referenced time contained the rule of then section 856(b)(6)(G), permitting property held at least 2 years and otherwise qualifying for the safe harbor to qualify for the safe harbor if it is sold to a qualified conservation organization for qualified conservation purposes (as those terms are defined in sections 170(h)(3) and 170(h)(1)(C), respectively).[186]

REITs engaged in timber activities

If a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)). The fair market value of the timber on the first day of the taxable year in which the timber is cut is used to determine the gain attributable to such cutting. Such fair market value is also considered the taxpayer's cost of the cut timber for all purposes, such as to determine the taxpayer's income from later sales of the timber or timber products. Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (sec. 631(b)). This treatment under either section 631(a) or 631(b) requires that the taxpayer has owned the timber or held the contract right for a period of more than one year.

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The IRS has issued private letter rulings in particular instances stating that the income from the sale of the trees under section 631(b) can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[187]

Under the Food, Conservation, and Energy Act of 2008, for the first taxable year of a REIT beginning after May 22, 2008 and before May 22, 2009, the Code specifically includes timber gain under section 631(a) as a category of statutorily recognized qualified real estate

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185 Sec. 857(b)(6)(C) (v) and section 857(b)(6)(D)(v).

186 If the sale was not to a qualified conservation organization for qualified conservation purposes, a 4-year holding period was required, and the limits on certain expenditures were computed by reference to a 4-year period.

187 Timber income under section 631(b) has also been held to be qualified real estate income even if the one year holding period is not met. See, e.g., PLR 200052021, *see also* PLR 199945055, PLR 199927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

income of a REIT if the cutting is provided by a taxable REIT subsidiary, and also includes gain recognized under section 631(b). For purposes of such qualified income treatment under those provisions, the requirement of a one-year holding period is removed. Thus, for example, a REIT can acquire timber property and harvest the timber on the property within one year of the acquisition, with the resulting income being qualified real estate income for REIT qualification purposes, even though such income is not eligible for long-term capital gain treatment under sections 631(a) or 631(b). The temporary Code rule specifically provides, however, that for all purposes of the Code, such income shall not be considered to be gain described in section 1221(a)(1), that is, it shall not be treated as income from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REITs trade or business. In addition, for such first taxable year, the Code specifically provides that for purposes of determining REIT income, if the cutting is done by a taxable REIT subsidiary, the cut timber is deemed sold on the first day of the taxable year to the taxable REIT subsidiary (with subsequent gain, if any, attributable to the taxable REIT subsidiary).

Explanation of Provision

The provision extends all of the otherwise expiring REIT timber provisions that were enacted in the Food, Conservation, and Energy Act of 2008, through the end of the first taxable year of a REIT beginning before December 31, 2010.

Effective Date

The provision is effective for REIT taxable years ending after May 22, 2009.

21. Treatment of certain dividends of regulated investment companies (sec. 151 of the bill and sec. 871(k) of the Code)

Present Law[188]

In general

A regulated investment company ("RIC") is an entity that meets certain requirements, including a requirement that its income generally be derived from passive investments such as dividends and interest, that it distribute 90 percent of its income, and that elects to be taxed under a special tax regime. Unlike an entity taxed as a corporation, an entity that is taxed as a RIC can deduct amounts paid to its shareholders as dividends. In this manner, tax on RIC income is generally not paid by the RIC but rather by its shareholders. However, income of a RIC is treated as a dividend by those shareholders, unless other special rules apply. Dividends received by foreign persons from a RIC are generally subject to gross-basis tax under sections 871(a) or 881, and the RIC payor of such dividends is obligated to withhold such tax under sections 1441 and 1442.

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[188] Secs. 871(k), 881, 1441 and 1442.

Under present law, a RIC that earns certain interest income that would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally can treat such a dividend as exempt from gross-basis U.S. tax, as if the foreign person had earned the interest directly. Also, subject to certain requirements, the RIC is exempt from withholding the gross basis tax on such dividends. Similar rules apply with respect to the designation of certain short term capital gain dividends. However, these provisions relating to certain dividends with respect to interest income and short term capital gain of the RIC do not apply to dividends with respect to any taxable year of a RIC beginning after December 31, 2009.

Explanation of Provision

The provision extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and short term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2011.

Effective Date

The provision applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2009 (but before January 1, 2011).

22. Treatment of RICs as "qualified investment entities" under section 897 (FIRPTA) (sec. 152 of the bill and sec. 897 of the Code)

Present law

Special U.S. tax rules apply to capital gains of foreign persons that are attributable to dispositions of interests in U.S. real property. In general, although a foreign person (a foreign corporation or a nonresident alien individual) is not generally taxed on U.S. source capital gains unless certain personal presence or active business requirements are met, a foreign person who sells a U.S. real property interest ("USRPI") is subject to tax at the same rates as a U.S. person, under the Foreign Investment in Real Property Tax Act ("FIRPTA") provisions codified in section 897 of the Code. Withholding tax is also imposed under section 1445.

A USRPI includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation (as defined) during the testing period. A USRPI does not include an interest in a domestically controlled "qualified investment entity." A distribution from a "qualified investment entity" that is attributable to the sale of a USRPI is also subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United Sates and the recipient foreign corporation or nonresident alien individual did not hold more than 5 percent of that class of stock or beneficial interest within the 1-year period ending on the date of distribution. Special rules apply to situations involving tiers of qualified investment entities.

The term "qualified investment entity" includes a regulated investment company ("RIC") that meets certain requirements, although the inclusion of a RIC in that definition is scheduled to expire, for certain purposes, on December 31, 2009.[189]

Explanation of Provision

The provision extends the inclusion of a RIC within the definition of a "qualified investment entity" under section 897 of the Code through December 31, 2010, for those situations in which that inclusion would otherwise expire at the end of 2009.

Effective Date

The provision is generally effective on January 1, 2010.

However, the provision does not apply to impose a withholding requirement under section 1445 that would not otherwise be imposed but for the provision, for any payment made before the date of enactment. A regulated investment company that makes a distribution after December 31, 2009 and before the date of enactment which would, but for that exception, have been required to withhold under section 1445, shall not be liable to any person to whom such distribution was made for any amount so withheld and paid over to the Secretary of the Treasury.

23. Subpart F exception for active financing income (sec. 153 of the bill and secs. 953 and 954 of the Code)

Present Law

Under the subpart F rules,[190] 10-percent-or-greater 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 real estate mortgage investment conduits ("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

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[189] Section 897(h).

[190] Secs. 951-964.

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.[191]

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, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income"). These provisions were enacted in the Taxpayer Relief Act of 1997 as one-year temporary exceptions, and in 1998, 1999, 2002, 2006, and 2008, the provisions were extended, and in some cases, modified.[192]

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 active financing 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.

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[191] Prop. Treas. Reg. sec. 1.953-1(a).

[192] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). 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. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009. The Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) extended the temporary provisions for one year, for taxable years beginning after 2008 and before 2010.

In the case of a securities dealer, the temporary exception from foreign personal holding company income applies to certain income. The income covered by the exception is any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475. In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that this exception generally takes precedence over the exception for income of a banking, financing or similar business, in the case of a securities dealer.

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. In the case of insurance, temporary exceptions from insurance income and from foreign personal holding company income also 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 under rules specific to the temporary exceptions. Present law also 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.

Explanation of Provision

The provision extends for one year (for taxable years beginning before 2011) 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, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

24. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company rules (sec. 154 of the bill and sec. 954(c)(6) of the Code)

Present Law

In general

The rules of subpart F[193] 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. There are several exceptions to these rules. For example, 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. In addition, subpart F income of a CFC does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

The "look-through rule"

Under the "look-through rule" (sec. 954(c)(6)), dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), 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 income of the payor that is neither subpart F income nor treated as ECI. 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 Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-through rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

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[193] Secs. 951-964.

The look-through rule is effective for taxable years of foreign corporations beginning before January 1, 2010, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Explanation of Provision

The provision extends for one year the application of the look-through rule, to taxable years of foreign corporations beginning before January 1, 2011, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

25. Reduction in corporate rate for qualified timber gain (sec. 155 of the bill and sec. 1201 of the Code)

Present Law

If a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)). The fair market value of the timber on the first day of the taxable year in which the timber is cut is used to determine the gain attributable to such cutting. Such fair market value is also considered the taxpayer's cost of the cut timber for all purposes, such as to determine the taxpayer's income from later sales of the timber or timber products. Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (sec. 631(b)). This treatment under either section 631(a) or (b) requires that the taxpayer has owned the timber or held the contract right for a period of more than one year.

Under present law, for the period ending May 22, 2009, a 15-percent alternative tax rate applies to a corporation on the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the net capital gain) for a taxable year. The alternative 15-percent tax rate applies to both the regular tax and the corporate alternative minimum tax.

For this purpose, qualified timber gain means the net gain described in section 631(a) and 631(b) for the taxable year, determined by taking into account only timber held more than 15 years.

Explanation of Provision

The provision extends the 15-percent rate for timber gain for periods before January 1, 2011.

Effective Date

The provision applies to taxable years ending after May 22, 2009.

26. Basis adjustment to stock of S corporations making charitable contributions of property (sec. 156 of the bill 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.[194] 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.[195]

In the case of contributions made in taxable years beginning before January 1, 2010, 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 is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. For contributions made in taxable years beginning after December 31, 2009, the amount of the reduction is the shareholder's pro rata share of the fair market value of the contributed property.

Explanation of Provision

The provision extends the rule relating to the basis reduction on account of charitable contributions of property for one year to contributions made in taxable years beginning before January 1, 2011.

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2009.

27. Empowerment zone tax incentives (sec. 157 of the bill and secs. 1391 and 1202 of the Code)

Present Law

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 93")[196] authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within certain targeted areas[197] designated by the Secretaries

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[194] Sec. 1366(a)(1)(A).

[195] Sec. 1367(a)(2)(B).

[196] Pub. L. No. 103-66.

[197] The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

of the Department of Housing and Urban Development ("HUD") and the U.S Department of Agriculture ("USDA"). The Taxpayer Relief Act of 1997[198] authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones ("Round II empowerment zones"). The Community Renewal Tax Relief Act of 2000 ("2000 Community Renewal Act")[199] authorized a total of ten new empowerment zones ("Round III empowerment zones"), bringing the total number of authorized empowerment zones to 40.[200] In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009.[201]

The tax incentives available within the designated empowerment zones include a Federal income tax credit for employers who hire qualifying employees, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, deferral of capital gains tax on sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock.

The following is a description of the tax incentives that are currently all scheduled to expire as of December 31, 2009.

Employment 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 empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.[202]

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[198] Pub. L. No. 105-34.

[199] Pub. L. No. 106-554.

[200] The urban part of the program is administered by the HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA, Baltimore, MD, Chicago, IL, Cleveland, OH, Detroit, MI, Los Angeles, CA, New York, NY, and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY, Mid-Delta, MI, and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA, Cincinnati, OH, Columbia, SC, Columbus, OH, Cumberland County, NJ, El Paso, TX, Gary/Hammond/East Chicago, IN, Ironton, OH/Huntington, WV, Knoxville, TN, Miami/Dade County, FL, Minneapolis, MN, New Haven, CT, Norfolk/Portsmouth, VA, Santa Ana, CA, and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA, Griggs-Steele, ND, Oglala Sioux Tribe, SD, Southernmost Illinois Delta, IL, and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA, Jacksonville, FL, Oklahoma City, OK, Pulaski County, AR, San Antonio, TX, Syracuse, NY, Tucson, AZ, and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME, and Futuro, TX.

[201] If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

[202] Sec. 1396. The $15,000 limit is annual, not cumulative such that the limit is the first $15,000 of wages paid in a calendar year which ends with or within the taxable year.

The wage credit rate applies to qualifying wages paid before January 1, 2010. 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 empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business."[203]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[204] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[205] 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.[206] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[207]

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $285,000 in 2009 and $169,000 in 2010[208]) for qualified zone property placed in service before January 1, 2010.[209] 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 $500,000.[210] The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a

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[203] Secs. 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, 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.

[204] Sec. 280C(a).

[205] Secs. 1396(c)(3)(A) and 51A(d)(2).

[206] Secs. 1396(c)(3)(B) and 51A(d)(2).

[207] Sec. 38(c)(2).

[208] Note that if the Section 179 limitation is extended by this legislation, the 2010 amount will be $285,000.

[209] Secs. 1397A, 1397D.

[210] Sec. 1397A(a)(2), 179(b)(2), (7). For 2008 and 2009, the limit is $800,000.

trade or business by the taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[211]

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.[212]

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.[213] In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental

[211] Sec. 1397C(b).

[212] Sec. 1397C(c).

[213] Sec. 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. Sec. 144(c)(6).

income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

Expanded tax-exempt financing for certain zone facilities

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.[214] These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).[215]

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed $60 million for an empowerment zone in a rural area, $130 million for an empowerment zone in an urban area with zone population of less than 100,000, and $230 million for an empowerment zone in an urban area with zone population of at least 100,000.

Elective roll over of capital gain from the sale or exchange of any qualified empowerment zone asset purchased after December 21, 2000

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset[216] held for more than one year and replaced within 60 days by another qualified

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[214] Sec. 1394.

[215] Sec. 1394(b)(3).

[216] The term "qualified empowerment zone asset" means any property which would be a qualified community asset (as defined in section 1400F, relating to certain tax benefits for renewal communities) if in section 1400F: (i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in section 1397C) were substituted for references to renewal community

empowerment zone asset in the same zone.[217] The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

Partial exclusion of capital gains on certain small business stock

For taxpayers other than corporations, 50 percent of the gain from the sale of qualified small business stock held for more than five years is excluded from gross income.[218] In the case of qualified small business stock acquired after December 21, 2000, in a corporation which is a qualified business entity (as defined in section 1397C(b)) during substantially all of the taxpayer's holding period, the exclusion is increased to 60 percent.[219] The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[220] A percentage of the excluded gain is an alternative minimum tax preference;[221] the portion of the gain includible in alternative minimum taxable income ("AMTI") is taxed at a maximum rate of 28 percent under the AMT.

The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

For all qualified small business stock acquired after February 17, 2009, and before January 1, 2011, the exclusion is increased to 75 percent. As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at

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businesses, and (iii) the date of the enactment of this paragraph were substituted for "December 31, 2001" each place it appears. Sec. 1397B(b)(1)(A).

A "qualified community asset" includes: (1) qualified community stock (meaning original-issue stock purchased for cash in an enterprise zone business), (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in an enterprise zone business), and (3) qualified community business property (meaning tangible property originally used in a enterprise zone business by the taxpayer) that is purchased or substantially improved after the date of the enactment of this paragraph.

For the definition of "enterprise zone business," see text accompanying *supra* note 211. For the definition of "qualified business," see text accompanying *supra* note 211.

[217] Sec. 1397B.

[218] Sec. 1202.

[219] The increased exclusion does not apply to gain attributable to periods after December 31, 2014.

[220] Sec. 1(h).

[221] Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in an taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

maximum effective rates of seven percent under the regular tax[222] and 12.88 percent under the AMT.[223]

Other tax incentives

Other incentives not specific to empowerment zones but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to $2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone, or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the period for which the designation of an empowerment zone is in effect, thus extending for one year the empowerment zone tax incentives, including the wage credit, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, and deferral of capital gains tax on sale of qualified assets sold and replaced.

The provision extends for one year, through December 31, 2015, the period for which gain from the sale or exchange of qualified business stock held for more than five years is excluded from gross income.

Effective Date

The provision relating to the designation of an empowerment zone and the provision relating to the exclusion of gain from the sale or exchange of qualified small business stock held for more than five years applies to periods after December 31, 2009.

28. Tax incentives for investment in the District of Columbia (sec. 158 of the bill and secs. 1400, 1400A, 1400B, and 1400C of the Code)

Present Law

In general

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the "District of Columbia Enterprise Zone," or "DC Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that comprise the District of Columbia Enterprise Zone are (1) all census tracts that

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[222] The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

[223] The 46 percent of gain included in AMTI is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

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 of Columbia), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The District of Columbia Enterprise Zone designation remains in effect for the period from January 1, 1998, through December 31, 2009.

The following tax incentives are available for businesses located in an empowerment zone and the District of Columbia Enterprise Zone is treated as an empowerment zone for this purpose: (1) 20-percent wage credit, (2) an additional $35,000 of section 179 expensing for qualified zone property, and (3) expanded tax-exempt financing for certain zone facilities. In addition, a zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years.

Present law also provides for a nonrefundable tax credit for first-time homebuyers of a principal residence in the District of Columbia.

Employment 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 District of Columbia, and (2) performs substantially all employment services within an empowerment zone in a trade or business of the employer.

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. 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 empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an "enterprise zone business," as defined below.

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year. Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A. 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. The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional $35,000 of section 179 expensing (for a total of up to $285,000 in 2009) for qualified zone property placed in service after December 31, 2001, and before January 1, 2010. 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 $500,000. The term "qualified zone property" is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. For this purpose, special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit. In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

Expanded tax-exempt financing for certain zone facilities

An enterprise zone business is permitted to borrow proceeds from the issuance of tax-exempt enterprise zone facility bonds (as defined in section 1394, without regard to the employee residency requirement) issued by the District of Columbia. To qualify, 95 percent (or more) of the net proceeds must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property. Accordingly, most of the proceeds have to be used to finance certain facilities within the DC Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per enterprise zone business may not exceed $15 million and may be issued only while the DC Zone designation is in effect, from January 1, 1998 through December 31, 2009.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified DC Zone assets held for more than five years. In general, a "qualified DC Zone asset" means stock or partnership interests held in, or tangible property held by, a DC Zone business. For purposes of the zero-percent capital gains rate, the DC Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than ten percent.

In general, gain eligible for the zero-percent tax rate is that from the sale or exchange of a qualified DC Zone asset that is (1) a capital asset or (2) property used in a trade or business, as defined in section 1231(b). 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 DC Zone business. However, no gain attributable to periods before January 1, 1998, and after December 31, 2014, is qualified capital gain.

District of Columbia homebuyer tax credit

First-time homebuyers of a principal residence in the District of Columbia qualify for a tax credit of up to $5,000. The $5,000 maximum credit amount applies both to individuals and married couples. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000 and $130,000 for joint filers). The credit is available with respect to purchases of existing property as well as new construction.

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies. A taxpayer will be treated as a first-time homebuyer with respect to only one residence--i.e., a taxpayer may claim the credit only once. A taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.

The first-time homebuyer credit is a nonrefundable personal credit and may offset the regular tax and the alternative minimum tax. Any credit in excess of tax liability may be carried forward indefinitely. The homebuyer credit is generally available for property purchased after August 4, 1997, and before January 1, 2010. However, the credit does not apply to the purchase of a residence after December 31, 2008 to which the national first-time homebuyer credit under Section 36 of the Code applies.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the designation of the District of Columbia Enterprise Zone.

The provision extends for one year the zero-percent capital gains rate applicable to capital gains from the sale or exchange of any DC Zone asset held for more than five years (and, as amended, acquired or substantially improved before January 1, 2011). The provision also extends for one year the period to which the term "qualified capital gain" refers. As amended, the term "qualified capital gain" shall not include any gain attributable to periods before January 1, 1998, or after December 31, 2015.

The provision extends the first-time homebuyer credit for one year (as amended, to apply to property purchased before January 1, 2011).

Effective Date

The provision extending the period of designation of the District of Columbia Enterprise Zone and the provision extending the period for which the term "qualified capital gain" refers applies to periods after December 31, 2009. The provision extending tax-exempt financing for certain zone facilities applies to bonds issued after December 31, 2009. The provision amending the definitions of DC Zone business stock, DC Zone partnership interest, and DC Zone business property applies to property acquired or substantially approved after December 31, 2009. The provision extending the first-time homebuyer credit applies to property purchased after December 31, 2009.

29. Renewal community tax incentives (sec. 159 of the bill and secs. 1400E, 1400F, 1400I, and 1400J of the Code)

Present Law

The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, authorized the designation of 40 "renewal communities" within which special Federal tax incentives are available to attract business and investment to distressed urban and rural areas. The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

The Secretary of Housing and Urban Development has awarded renewal community designations to 40 selected communities (28 urban and 12 rural), including areas that remained distressed after previously having received empowerment zone or enterprise community designations.[224] To qualify as a renewal community, the community must have (1) a minimum unemployment rate of 9.45 percent (versus 6.3 percent for enterprise communities and empowerment zones) and (2) a minimum population of 4,000 within a metro area or 1,000 otherwise and a maximum population of 200,000. The designation of an area as a renewal community is effective on January 1, 2002, and terminates after December 31, 2009.[225]

The tax incentives provided under the renewal communities program include a Federal income tax credit for employers who hire qualifying employees, enhanced tax deductions on qualifying equipment and expenditures to construct or rehabilitate certain nonresidential buildings, and capital gains tax exclusion on sales of qualified assets. The tax incentives for renewal communities generally are available through December 31, 2009.[226]

The following is a description of these tax incentives.

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[224] The 28 urban renewal communities are: Mobile, AL; Los Angeles, San Diego, and San Francisco, CA; Atlanta, GA; Chicago, IL; New Orleans and Ouachita Parish, LA; Lawrence and Lowell, MA; Detroit and Flint, MI; Camden and Newark, NJ; Buffalo-Lackawanna, Niagara Falls, Rochester, and Schenectady, NY; Hamilton and Youngstown, OH; Philadelphia, PA; Charleston, SC; Chattanooga and Memphis, TN; Corpus Christi, TX; Tacoma and Yakima, WA; and Milwaukee, WI.

The 12 rural renewal communities are: Greene-Sumter, AL; Southern Alabama; Orange Cove and Parlier, CA; Eastern Kentucky; Central and Northern Louisiana; West-Central Mississippi; Turtle Mountain Band of Chippewa, ND; Jamestown, NY; El Paso County, TX; and Burlington, VT.

[225] The designation would terminate earlier than December 31, 2009, if (1) an earlier termination date is so designated by the State or local government, or (2) the Secretary of HUD revokes the designation as of an earlier date.

[226] If a renewal community designation is terminated prior to December 31, 2009, the tax incentives cease to be available as of the termination date.

Renewal community employment credit

A 15-percent wage credit is available to employers for the first $10,000 of qualified wages paid to each employee (i.e., a maximum credit of $1,500 with respect to each qualified employee) who (1) is a resident of the renewal community, and (2) performs substantially all employment services within the renewal community in a trade or business of the employer.[227]

The wage credit applies to qualifying wages paid before January 1, 2010. Wages paid to a qualified employee who earns more than $10,000 are eligible for the wage credit (although only the first $10,000 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 renewal community may claim the wage credit, regardless of whether the employer meets the definition of a "renewal community business."[228]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[229] Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[230] In addition, the $10,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[231] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[232]

Additional section 179 expensing

A renewal community business (as defined below in connection with the zero-percent capital gains rate) is allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service before January 1, 2010.[233] The section 179 expensing

[227] Sec. 1400H. This section treats a renewal community as an empowerment zone for purposes of section 1396 with respect to wages paid or incurred after December 31, 2001, subject to modifications of the applicable percentage amount (15 percent instead of 20 percent) and the qualified wage amount ($10,000 instead of $15,000).

[228] Sec. 1400G. 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 5 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.

[229] Sec. 280C(a).

[230] Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

[231] Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

[232] Sec. 38(c)(2).

[233] Sec. 1400J.

allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds $500,000.[234]

The term "qualified renewal 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 renewal community commences with the taxpayer, and (3) substantially all of the use of the property is in the renewal community in the active conduct of a trade or business by the taxpayer.[235] Special rules are provided in the case of property that is substantially renovated by the taxpayer.

Commercial revitalization deduction

Each State is permitted to allocate up to $12 million of commercial revitalization expenditures to each renewal community located within the State for each calendar year after 2001 and before 2010. The appropriate State agency will make the allocations pursuant to a qualified allocation plan.[236]

A commercial revitalization expenditure means the cost of a new building or the cost of substantially rehabilitating an existing building. The building must be used for commercial purposes and be located in a renewal community. In the case of the rehabilitation of an existing building, the cost of acquiring the building will be treated as a qualifying expenditure only to the extent that such costs do not exceed 30 percent of the other rehabilitation expenditures. The qualifying expenditures for any building cannot exceed $10 million.

A taxpayer can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed in service.[237] No depreciation is allowed for amounts deducted under this provision. The adjusted basis of the building is reduced by the amount of the commercial revitalization deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules.

The commercial revitalization deduction is treated in the same manner as the low-income housing credit in applying the passive loss rules. Thus, up to $25,000 of deductions (together with the other deductions and credits not subject to the passive loss limitation by reason of section 469(i)) are allowed to an individual taxpayer regardless of the taxpayer's adjusted gross income. The commercial revitalization deduction is allowed in computing a taxpayer's alternative minimum taxable income.

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[234] Sec. 1400J, 179(b)(2), 179(b)(7). For 2008 and 2009, the limit is $800,000.

[235] Secs. 1400J(b), 1397D.

[236] Sec. 1400I.

[237] Sec. 1400I.

Zero-percent capital gains rate

A zero-percent capital gains rate applies with respect to gain from the sale of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years.[238] A qualified community asset includes: (1) qualified community stock (meaning original-issue stock purchased for cash in a renewal community business); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible property originally used in a renewal community business by the taxpayer) that is purchased or substantially improved after December 31, 2001.

A renewal community business is defined as a corporation or partnership (or proprietorship) if for the taxable year (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business[239] within a renewal community; (2) at least 50 percent of the total gross income is derived from the active conduct of a "qualified business" within a renewal community; (3) a substantial portion of the business's tangible property is used within a renewal community; (4) a substantial portion of the business's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a renewal community; (6) at least 35 percent of the employees are residents of the renewal community; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Property will continue to be a qualified community asset if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or tangible property used in) a renewal community business.

The termination of an area's status as a renewal community will not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2002, or after December 31, 2014, is not eligible for the zero-percent rate.

Other tax incentives

Other incentives not specific to renewal communities but beneficial to these areas include the work opportunity tax credit for employers based on the first year of employment of certain targeted groups, including renewal community residents (up to $2,400 per employee), and

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[238] Sec. 1400F.

[239] A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, the leasing of real property that is located within the renewal community is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from renewal community businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of a renewal community.

qualified zone academy bonds for certain public schools expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced-cost lunches.

Explanation of Provision

The provision extends for one year, through December 31, 2010, the period for which the designation of a renewal community is in effect.

The provision extends for one year, through January 1, 2011, the period for which the taxpayer can acquire a qualified community asset defined to include qualified community stock, a qualified community partnership interest, and qualified community business property. The provision extends for one year, through December 31, 2015, the period for which qualified capital gain from the sale or exchange of a qualified community asset held for more than five years is excluded from gross income.

The provision extends for one year, through December 31, 2010, the period for which a taxpayer can place a qualified revitalization building in service for purposes of the commercial revitalization deduction.

The provision extends for one year, through December 31, 2010, the period through which the taxpayer can acquire qualified renewal property.

Effective Date

The provision relating to the designation of a renewal community and the provision relating to the exclusion of gain from the sale or exchange of a qualified community asset held for more than five years applies to periods after December 31, 2009. The provision relating to the period for which the taxpayer can acquire a qualified community asset or qualified renewal property applies to acquisitions after December 31, 2009. The provision relating to the placed in service date for qualified revitalization buildings eligible for the commercial revitalization deduction applies to buildings placed in service after December 31, 2009.

30. Temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands (sec. 160 of the bill and sec. 7652(f) of the Code)

Present Law

A $13.50 per proof gallon[240] excise tax is imposed on distilled spirits produced in or imported into the United States.[241] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[242]

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[240] A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

[241] Sec. 5001(a)(1).

[242] Secs. 5214(a)(1)(A), 5002(a)(15), 7653(b) and (c).

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[243] The amount of the cover over is limited under Code section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon before January 1, 2010).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[244] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[245] All of the amounts covered over are subject to the limitation.

Explanation of Provision

The provision suspends for one year the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over limitation of $13.25 per proof gallon is extended for rum brought into the United States after December 31, 2009 and before January 1, 2011. After December 31, 2010, the cover over amount reverts to $10.50 per proof gallon.

Effective Date

The provision is effective for articles brought into the United States after December 31, 2009.

31. American Samoa economic development credit (sec. 161 of the bill and sec. 119 of Pub. L. No. 109-432)

Present and Prior Law

In general

For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit.[246] This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions.

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

244 Sec. 7652(e)(2).

245 Secs. 7652(a)(3), (b)(3), and (e)(1).

246 Secs. 27(b), 936.

For purposes of the credit, possessions included, among other places, American Samoa. Subject to certain limitations described below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment.[247] No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under section 936.[248] The section 936 credit generally expired for taxable years beginning after December 31, 2005, but a special credit, described below, was allowed with respect to American Samoa.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to 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 was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

The possession tax credit was available only to a corporation that qualified as an existing credit claimant. The determination of whether a corporation was an existing credit claimant was made separately for each possession. The possession tax credit was computed separately for each possession with respect to which the corporation was an existing credit claimant, and the credit was subject to either an economic activity-based limitation or an income-based limitation.

Qualification as existing credit claimant

A corporation was 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.[249] A corporation that added 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) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

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[247] Under phase-out rules described below, investment only in Guam, American Samoa, and the Northern Mariana Islands (and not in other possessions) now may give rise to income eligible for the section 936 credit.

[248] Sec. 936(c).

[249] 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.

Economic activity-based limit

Under the economic activity-based limit, the amount of the credit determined under the rules described above was not permitted to exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes.

Income-based limit

As an alternative to the economic activity-based limit, a taxpayer was permitted to elect to apply a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income; in taxable years beginning in 1998 and subsequent years, the applicable percentage was 40 percent.

Repeal and phase out

In 1996, the section 936 credit was repealed for new claimants for taxable years beginning after 1995 and was phased out for existing credit claimants over a period including taxable years beginning before 2006. The amount of the available credit during the phase-out period generally was reduced by special limitation rules. These phase-out period limitation rules did not apply to the credit available to existing credit claimants for income from activities in Guam, American Samoa, and the Northern Mariana Islands. As described previously, the section 936 credit generally was repealed for all possessions, including Guam, American Samoa, and the Northern Mariana Islands, for all taxable years beginning after 2005, but a modified credit was allowed for activities in American Samoa.

American Samoa economic development credit

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006 is allowed a credit based on the economic activity-based limitation rules described above. The credit is not part of the Code but is computed based on the rules of sections 30A and 936. The credit is allowed for the first four taxable years of a corporation that begin after December 31, 2005, and before January 1, 2010.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation (described previously) with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under section 936 does not apply with respect to the credit allowed by the provision.

The credit is not available for taxable years beginning after December 31, 2009.

Explanation of Provision

The provision allows the American Samoa economic development credit to apply for the first five taxable years of a corporation that begin after December 31, 2005, and before January 1, 2011.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

D. Temporary Disaster Relief Provisions

1. Special rules for mortgage revenue bonds in Federally declared disaster areas (sec. 171 of the bill and sec. 143 of the Code)

Present Law

Qualified mortgage bonds

Generally

Under present law, gross income does not include interest on State or local bonds.[250] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds that are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") (secs. 103(b)(1) and 141).

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, qualified home improvement, or rehabilitation of owner-occupied residences.

The Code imposes several limitations on qualified mortgage bonds in the case of a purchase of a residence, including purchase price limitations for the residence financed with bond proceeds and income limitations for homebuyers. In general, the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 90 percent of the average area purchase price (i.e., the average single-family residence purchase price purchased for the most recent one-year period in the statistical area in which the residence is located) (sec. 143(e)). The income limitation generally is met if all the owner-financing provided under the issue is provided to individuals who have family income of 115 percent or less of the applicable median family income (sec. 143(f)).

Qualified home improvement loans are defined as financing, not in excess of $15,000, of alterations, repairs, and improvements on or in connection with an existing residence by an owner thereof. These are further limited only to such items as substantially protect or improve the basic livability or energy efficiency of the property.

Rehabilitation loans are eligible for such financing if: (1) the mortgagor receiving the financing is the first resident after the completion of the rehabilitation; (2) at least 20 years have elapsed between the first use of the residence and the start of the physical work of the rehabilitation; (3) certain percentages of internal and external walls are retained after the

[250] Sec. 103

rehabilitation; and (4) rehabilitation expenditures equal at least 25 percent of the taxpayer's adjusted basis in the residence after such rehabilitation (sec. 143(k)(5)).

First-time homebuyers

In addition to the purchase price and income limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement) (sec. 143(d)). The first-time homebuyer requirement does not apply to targeted area residences (described below).

Special rules for targeted area residences

A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress (sec. 143(j)).

In addition to the waiver of the first-time homebuyer rule, targeted area residences have special purchase price limitations and income limitations. For targeted area residences, the purchase price limitation is applied by substituting 110 percent for 90 percent (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence) (sec. 143(e)(5)). For targeted area residences, the income limitation generally is met if at least two-thirds of all the owner-financing provided under the issue is provided to individuals who have family income of 140 percent or less of the applicable median family income. The other third is not subject to an income limitation (sec. 143(f)(3)).

Special rules for Federally declared disaster areas

A temporary provision waives the first-time homebuyer requirement for residences located in Federally declared disaster areas (sec. 143(k)(11)). Also, under the provision, residences located in Federally declared disaster areas are treated as targeted area residences for purposes of the income and purchase price limitations. The special rules for residences located in Federally declared disaster areas applies to bonds issued after May 1, 2008, and before January 1, 2010.

Election to waive certain mortgage revenue bond rules

In general

Present law allows certain taxpayers affected by natural disasters to elect to waive the first-time homebuyer requirement and modify the purchase price limitation from 90 percent to 110 percent, if the taxpayer's principal residence is destroyed as a result of a Federally declared disaster. Any owner-financing provided with respect to repair or reconstruction is deemed a qualified rehabilitation loan, if the taxpayer's principal residence is damaged as a result of a Federally declared disaster. If a taxpayer makes such an election, then the otherwise applicable special rules for Federally declared disaster areas do not apply. If there is no such election, then the otherwise applicable special rules for Federally declared disaster areas apply.

Principal residence destroyed

This election for destroyed residences is available for principal residences located in Federally declared disaster areas when the principal residence of a taxpayer is: (1) rendered unsafe for use by reason of a Federally declared disaster occurring before January 1, 2010; or (2) demolished or relocated by reason of an order of the government of a State or political subdivision thereof on account of a Federally declared disaster occurring before January 1, 2010. This election applies for the two-year period beginning on the date of the disaster.

The election provides for: (1) a waiver of the first-time homebuyer requirement; and (2) the purchase price limitation otherwise applicable to targeted area residences (i.e., the purchase price limitation is met if the acquisition cost of each residence financed does not exceed 110 percent of the average area purchase applicable to the residence).

Principal residence damaged

The election for damaged residences allows certain taxpayers to elect to waive the otherwise applicable qualified rehabilitation loan rules and treat the cost of repair or reconstruction of a taxpayer's principal residence as a qualified rehabilitation loan. This election is limited to taxpayers whose principal residence is damaged as a result of a Federally declared disaster occurring before January 1, 2010. Such rehabilitation loans are limited to the lesser of $150,000 or the cost of repair or reconstruction.

Other rules

Once made, an election under these provisions may not be revoked by the taxpayer except with the consent of the Secretary.

For purposes of the provision, the term "Federally declared disaster" has the same definition as in section 165(h)(3)(C)(i) of the Code.[251] The provision is effective for disaster occurring after December 31, 2007. However, the provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.[252]

Explanation of Provision

The provision extends: (1) the special rules for Federally declared disaster areas; and (2) the election to waive certain mortgage revenue bond rules relating to Federally declared disasters for one additional year (through 2010).

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[251] Sec. 165 relates to personal casualty losses.

[252] Sec. 712 of Pub. L. No. 110-343 Div. C.

Effective Date

The provision relating to the special rules for Federally declared disaster areas is effective for bonds issued after December 31, 2009. The provision relating to the election to waive certain mortgage revenue bond rules relating to Federally declared disasters is effective for disasters occurring after December 31, 2009.

2. Deductibility of personal casualty losses attributable to Federally declared disasters (sec. 172 of the Act and sec. 165 of the Code)

Present Law

Personal casualty losses

In general

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[253] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of losses of property arising from fire, storm, shipwreck, or other casualty, or from theft.[254] In the case of any loss occurring in a disaster area and attributable to a Federally declared disaster area, the taxpayer may elect to take into account the casualty loss for the taxable year immediately preceding the taxable year in which the disaster occurs.[255]

Dollar limitation

In the case of an individual, a casualty or theft loss not connected with a trade or business or transaction entered into for profit ("personal casualty loss") is allowed only to the extent the loss exceeds $500 ($100 for taxable years beginning after December 31, 2009).[256]

Adjusted gross income limitation

In general, the net aggregate personal casualty losses for a taxable year are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.[257]

Present law waives the 10-percent of adjusted gross income limitation for a "net disaster loss." The term "net disaster loss" means the excess of personal casualty losses attributable to a

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[253] Sec. 165(a).

[254] Sec. 165(c).

[255] Sec. 165(i).

[256] Sec. 165(h)(1).

[257] Sec. 165(h)(2).

Federally declared disaster occurring before January 1, 2010, and occurring in a disaster area, over personal casualty gains. The term "Federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The term "disaster area" means the area so determined to warrant assistance.

Standard deduction

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions.[258] Unless an individual elects, no itemized deductions are allowed for the taxable year. The deduction for personal casualty losses is an itemized deduction.

Present law increases an individual taxpayer's standard deduction by the "disaster loss deduction." The "disaster loss deduction" means the net disaster loss (as defined above).

Explanation of Provision

One-year extension of net disaster loss

The provision extends for one year the definition of a net disaster loss to include personal casualty losses attributable to Federally declared disasters occurring in 2010. Thus the waiver of the 10-percent of adjusted gross income limitation for net disaster losses and the inclusion of net disaster losses in the standard deduction are extended for one year.

One-year extension of the increase to $500 limitation per casualty

The provision extends the $500 per casualty dollar limitation for one year to taxable years beginning after December 31, 2009, and before January 1, 2011.

Effective Dates

The provision generally applies to disasters occurring after December 31, 2009.

The provision increasing the limitation per casualty to $500 applies to taxable years beginning after December 31, 2009.

[258] Sec. 63.

3. Special depreciation allowance and expensing for qualified disaster assistance property (sec. 173 of the bill and secs. 168(n) and 179(e) of the Code)

Present Law

Special depreciation allowance

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS").[259] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Present law includes an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of any "qualified disaster assistance property."[260] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies.

Qualified disaster assistance property means any property-- (1) to which the general rules of the MACRS apply with (a) an applicable recovery period of 20 years or less, (b) computer software other than computer software covered by section 197, (c) water utility property (as defined in section 168(e)(5)), (d) certain leasehold improvement property, or (e) certain nonresidential real property and residential rental property; (2) substantially all of which is used in a disaster area with respect to a Federally declared disaster occurring before January 1, 2010, in the active conduct of a trade or business by the taxpayer in such disaster area; (3) which rehabilitates property damaged, or replaces property destroyed or condemned, as a result of the Federally declared disaster, except that property is treated as replacing property destroyed or condemned if, as part of an integrated plan, the property replaces property which is included in a continuous area which includes real property destroyed or condemned, and is similar in nature to, and located in the same county as, the property being rehabilitated or replaced; (4) the original use of the property in the disaster area commences with an eligible taxpayer (a taxpayer who has

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[259] Sec. 168.

[260] Sec. 168(n).

suffered an economic loss attributable to a Federally declared disaster) on or after the applicable disaster date (the date on which a Federally declared disaster occurs); (5) which is acquired by an eligible taxpayer by purchase (as defined under section 179(d)) by the taxpayer on or after the applicable disaster date (and no written binding contract for the acquisition was in effect before such date); and (6) which is placed in service by an eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (the fourth calendar year in the case of nonresidential real property and residential rental property).[261]

Qualified disaster assistance property does not include any property: (1) to which the special allowance for depreciation under section 168(k) (regardless of any election under section 168(k)(4)), section 168(l) for cellulosic biofuel property, or section 168(m) for reuse and recycling property applies; (2) to which the special allowance for qualified Gulf Opportunity Zone property under section 1400N(d) applies; (3) used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property (as defined in section 1400N(p)(3)(B)); (4) to which the alternative depreciation system under section 168(g) applies (determined without regard to the election to use such system under section 168(g)(7)); (5) any portion of which is financed with proceeds of any obligation the interest on which is exempt from tax under section 103; and (6) which is a qualified revitalization building with respect to which the taxpayer has made an election under section 1400I(a) to either expense one-half of qualified revitalization expenditures or recover such expenditures over 120 months.[262] A taxpayer may elect to not apply the rules of this provision with respect to any class of property for any taxable year.

The special rules of section 168(k)(2)(E) apply with modifications. For example, property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after the applicable disaster date, and which is placed in service by an eligible taxpayer on or before the date which is the last day of the third calendar year following the applicable disaster date (the fourth calendar year in the case of nonresidential real property and residential rental property). 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.

Recapture rules similar to section 179(d)(10) apply to any qualified disaster assistance property that ceases to be qualified disaster assistance property.

<u>Section 179 expensing</u>

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through

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[261] Sec. 168(n)(2)(A).

[262] Sec. 168(n)(2)(B).

depreciation deductions.[263] For taxable years beginning in 2009, the maximum amount that a taxpayer may expense is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 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 $800,000.[264] For taxable years beginning in 2010, the maximum amount that a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 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 $500,000. The $125,000 and $500,000 amounts are indexed for inflation.

Qualified disaster assistance property is eligible for increased dollar limits on expensing under section 179. Specifically, the maximum amount that a taxpayer may expense is increased by the lesser of $100,000 or the cost of qualified section 179 disaster assistance property placed in service in the taxable year. The $800,000 limitation (for taxable years beginning in 2009) is increased by the lesser of $600,000 or the cost of qualified section 179 disaster assistance property placed in service during the taxable year.[265]

Qualified section 179 disaster assistance property is depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software) that meets the definition of qualified disaster assistance property.[266] Thus, the provision applies with respect to property placed in service in a disaster area with respect to a Federally declared disaster occurring before January 1, 2010.

<u>Explanation of Provision</u>

The provision extends for one year the special depreciation allowance and expensing provisions for qualified disaster assistance property to apply to property placed in service in a disaster area with respect to a Federally declared disaster occurring before January 1, 2011.

<u>Effective Date</u>

The provision is effective for disasters occurring after December 31, 2009.

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[263] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[264] The temporary $250,000 and $800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, and extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

[265] Sec. 179(e)(1).

[266] Sec. 179(e)(2).

4. Net operating losses attributable to Federally declared disasters (sec. 174 of the bill and sec. 172 of the Code)

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.[267] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[268]

Section 172(b)(1)(J) provides a special five-year carryback period for NOLs to the extent of a qualified disaster loss. A qualified disaster loss is the lesser of: (1) the sum of (a) section 165 losses for the taxable year attributable to a Federally declared disaster[269] occurring after December 31, 2007, and before January 1, 2010, and occurring in a disaster area,[270] and (b) the deduction for the taxable year for qualified disaster expenses allowable under section 198A(a) or which would be allowable as a deduction under that section if not treated as an expense in another section of the Code; or (2) the NOL for the taxable year.

A qualified disaster loss does not include any loss with respect to any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, or any gambling or animal racing property (as defined in section 1400N(p)(3)(B)).

The amount of the NOL to which the five-year carryback period applies is limited to the amount of the corporation's overall NOL for the taxable year. Any remaining portion of the taxpayer's NOL is subject to the general two-year carryback period. Ordering rules similar to those for specified liability losses apply to losses carried back under section 172(b)(1)(J).

Any taxpayer entitled to the five-year carryback under section 172(b)(1)(J) may elect to have the carryback period determined without regard to this provision. In addition, the general rule which limits a taxpayer's NOL deduction to 90 percent of alternative minimum taxable income ("AMTI") does not apply to any NOL to which the five-year carryback period applies under the provision. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100 percent of AMTI.

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[267] Sec. 172(b)(1)(A).

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

[269] The term "Federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

[270] The term "disaster area" means the area so determined to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Section 172(b)(1)(J) does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

Explanation of Provision

The provision extends the five-year NOL carryback period for one year to apply to losses incurred in connection with Federally declared disasters occurring before January 1, 2011.

Effective Date

The provision is effective for losses attributable to disasters occurring after December 31, 2009.

5. Expensing of qualified disaster expenses (sec. 175 of the bill and sec. 198A of the Code)

Present Law

A taxpayer may elect to treat any qualified disaster expense that is paid or incurred by the taxpayer as a deduction for the taxable year in which paid or incurred. For purposes of the provision, a qualified disaster expense is any otherwise capitalizable expenditure paid or incurred in connection with a trade or business or with business-related property that is: (1) for the abatement or control of hazardous substances that were released on account of a Federally declared disaster[271] occurring before January 1, 2010; (2) for the removal of debris from, or the demolition of structures on, real property damaged or destroyed as a result of a Federally declared disaster occurring before January 1, 2010; or (3) for the repair of business-related property damaged as a result of a Federally declared disaster occurring before January 1, 2010. No inference is intended as to the proper present law treatment of expenditures to repair business-related property damaged in a casualty event. The purpose of the provision is to provide that, in any case in which such costs are otherwise required to be capitalized, the costs may be deducted in the taxable year paid or incurred to the extent incurred as a result of a Federally declared disaster.

For purposes of section 198A, "business-related property" is property held by the taxpayer for use in a trade or business, for the production of income, or as inventory. In addition, any deduction allowed under this provision is treated as a deduction for depreciation and section 1245 property for purposes of applying the depreciation recapture rules.

This provision does not apply to any disaster that has been declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford

[271] For these purposes, the term "Federally declared disaster" means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin.

Explanation of Provision

The provision extends the deduction for qualified disaster expenditures for one year to apply to amounts paid or incurred in connection with Federally declared disasters occurring before January 1, 2011.

Effective Date

The provision is effective for expenditures on account of disasters occurring after December 31, 2009.

6. Special depreciation allowance for certain New York Liberty Zone property (sec. 181 of the bill and sec. 1400L(b) of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS").[272] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Present law includes an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified New York Liberty Zone ("Liberty Zone") property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.

[272] Sec. 168.

For property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be eligible real property.[273] Second, substantially all of the use of such property must be in the Liberty Zone. Third, the original use[274] of the property in the Liberty Zone must commence with the taxpayer on or after September 11, 2001.[275] Finally, the property must be acquired by purchase[276] by the taxpayer on or after September 11, 2001.

Nonresidential real property and residential rental property are 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 is treated as replacing destroyed property, if as part of an integrated plan, such property replaces real property that is included in a continuous area that includes real property destroyed or condemned. It is intended that, for this purpose, real property destroyed (or condemned) only include circumstances in which an entire building or structure was destroyed (or condemned) as a result of the terrorist attacks. Otherwise, such property is considered damaged real property. For example, if certain structural components (e.g., wall, floors, or plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks, but the building is not destroyed (or condemned), then only costs related to replacing the damaged or destroyed components qualify for the provision.

Eligible real property that is constructed by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the construction of the property after September 11, 2001, and the property is placed in service on or before December 31, 2009 (assuming all other requirements are met). Property that is constructed for the taxpayer by another person under a contract that is entered into prior to the construction of the property is considered to be constructed by the taxpayer.[277]

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[273] For property acquired and placed in service prior to December 31, 2006, Liberty Zone property included property to which the general rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), or (3) computer software other than computer software covered by section 197. A special rule precluded the additional first-year depreciation under section 1400L(b) for qualified New York Liberty Zone leasehold improvement property and for property eligible for the additional first-year depreciation under section 168(k) (i.e., property is eligible for only one 30 percent additional first year depreciation).

[274] Thus, used property may constitute qualified property so long as it has not previously been used within the Liberty Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Liberty Zone began with the taxpayer would satisfy the "original use" requirement. See Treas. Reg. Sec. 1.48-2, Example 5.

[275] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

[276] For this purpose, purchase is defined under section 179(d).

[277] Similar rules applied with respect to the manufacture or production of tangible personal property for which the manufacture or production began after September 11, 2001, and that was placed in service on or before December 31, 2006.

The Liberty Zone means 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.

Explanation of Provision

The provision extends for one year the additional 30-percent depreciation deduction for eligible real property to apply to property placed in service on or before December 31, 2010.

Effective Date

The provision is effective for eligible real property placed in service after December 31, 2009.

7. New York Liberty Zone bond provision (sec. 182 of the bill and sec. 1400L of the Code)

Present Law

An aggregate of $8 billion in tax-exempt private activity bonds is authorized for the purpose of financing the construction and repair of infrastructure in New York City ("Liberty Zone bonds"). The bonds must be issued before January 1, 2010.

Explanation of Provision

The provision extends authority to issue Liberty Zone bonds for one year (through December 31, 2010).

Effective Date

The provision is effective for bonds issued after December 31, 2009.

8. Remove limitation on basis qualifying for Gulf Opportunity Zone additional depreciation allowance (sec. 183 of the bill and sec. 1400N(d)(6) of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS").[278] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The recovery periods for residential rental property and nonresidential real property are 27.5 years and 39 years, respectively. The depreciation methods

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[278] Sec. 168.

generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized. Nonresidential real property and residential rental property are depreciated using the straight-line method.

Present law includes an additional first-year depreciation deduction equal to 50-percent of the adjusted basis of specified Gulf Opportunity Zone extension property.[279] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.

Specified Gulf Opportunity Zone extension property is nonresidential real property or residential rental property, which is placed in service by the taxpayer by December 31, 2010, substantially all of the use of which is in one or more counties or parishes identified by the Secretary as being a county or parish in which hurricanes occurring in 2005 damaged more than 60 percent of the occupied housing units in the county or parish (determined according to the 2000 Census).[280] The amount of the additional depreciation allowance is limited to the adjusted basis of nonresidential real property or residential rental property attributable to manufacture, construction, or production occurring before January 1, 2010.[281]

Specified Gulf Opportunity Zone extension property does not include any property to which section 168(k) applies.

Explanation of Provision

The provision removes the limitation on the adjusted basis of nonresidential real and residential rental property taken into account in determining the amount of the additional depreciation allowance for specified Gulf Opportunity Zone extension property. As a result, the basis of real property eligible for the additional allowance is not limited to the adjusted basis attributable to the manufacture, construction, or production before January 1, 2010.

Effective Date

The provision is effective for specified Gulf Opportunity Zone extension property placed in service after December 31, 2009.

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279 Sec. 1400N(d)(6).

280 Sec. 1400N(d)(6)(B) and (C). These areas include the Louisiana parishes of Calcasieu, Cameron, Orleans, Plaquemines, St. Bernard, St. Tammany, and Washington, and the Mississippi counties of Hancock, Harrison, Jackson, Pearl River, and Stone. Notice 2007-36, 2007-17 I.R.B. 1000.

281 Sec. 1400N(d)(6)(D).

9. Increased rehabilitation credit for structures in the Gulf Opportunity Zone (sec. 184 of the bill and sec. 1400N(h) of the Code)

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Present law increases from 20 to 26 percent, and from 10 to 13 percent, respectively, the credit under section 47 with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone, provided the qualified rehabilitation expenditures with respect to such buildings or structures are incurred on or after August 28, 2005, and before January 1, 2010. The provision is effective for expenditures incurred on or after August 28, 2005, for taxable years ending on or after August 28, 2005.

Explanation of Provision

The provision extends for one additional year the increase in the rehabilitation credit from 20 to 26 percent, and from 10 to 13 percent, respectively, with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone. Thus, the increase applies for qualified rehabilitation expenditures with respect to such buildings or structures incurred before January 1, 2011.

Effective Date

The provision is effective upon date of enactment.

10. Work opportunity tax credit for Hurricane Katrina employees (sec. 185 of the bill)

Present Law

General work opportunity tax credit rules

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 nine targeted groups.

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

Generally, the credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients 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). In the case of certain qualified veterans, the definition of first-year wages is increased from $6,000 to $12,000, which increases the maximum credit per such employee to $4,800. Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of $10,000 for qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of $10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $9,000 (40 percent of the first $10,000 of qualified first-year wages plus 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.

Certification requirement

In general, an individual is not treated as a member of a targeted group unless (1) on or before the day on which such individual begins work for the employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group or (2) on or before the day the individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual and not later than the twenty-first day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under the penalties of perjury, to the designated local agency as part of a written request for such a certification from such agency.

Qualifying rehires

No credit is available for any individual if, prior to the hiring date of such individual, such individual had been employed by the employer at any time.

Other rules

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

Expiration date

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before September 1, 2011.

Hurricane Katrina work opportunity tax credit rules

In general

A Hurricane Katrina employee is treated as a member of a targeted group for purposes of the work opportunity tax credit. A Hurricane Katrina employee is: (1) an individual who on August 28, 2005, had a principal place of abode in the core disaster area and is hired during the four-year period beginning on such date for a position, the principal place of employment of which is located in the core disaster area.

Certification requirement

The WOTC certification requirement is waived for such individuals. In lieu of the certification requirement, an individual may provide to the employer reasonable evidence that the individual is a Hurricane Katrina employee.

Qualifying rehires

The general rule that denies the credit with respect to wages of employees who had been previously employed by the employer is waived for the first hire of such employee as a

Hurricane Katrina employee unless such employee was an employee of the employer on August 28, 2005.

Explanation of Provision

The provision extends the work opportunity tax credit for Hurricane Katrina employees for one year (through August 27, 2010).

Effective Date

The provision is effective for individuals hired after August 27, 2009 and before August 28, 2010.

11. Special rules for use of retirement funds (sec. 191 of the bill and secs. 72 and 1400Q of the Code)

Present Law

In general

Withdrawals from retirement plans

Under present law, a distribution from a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity under section 403(b) (a "403(b) annuity"), an eligible deferred compensation plan maintained by a State or local government under section 457 (a "governmental 457 plan"), or an individual retirement arrangement under section 408 (an "IRA") generally is included in income for the year distributed.[282] In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59-½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies.[283]

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a "401(k) plan") or in a 403(b) annuity may not be distributed before severance from employment, age 59-½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan may not be distributed before severance from employment, age 70-½, or an unforeseeable emergency of the employee.

An eligible rollover distribution from a qualified retirement or annuity plan, a 403(b) annuity, or a governmental 457 plan, or a distribution from an IRA, generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the

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[282] Secs. 402(a), 403(a), 403(b), 408(d), and 457(a). Plans qualified under these sections are referred to collectively as "eligible retirement plans".

[283] Sec. 72(t).

individual. Any amount rolled over is not includible in income (and thus also not subject to the 10-percent early withdrawal tax).

Distributions from a qualified retirement or annuity plan, 403(b) annuity, a governmental 457 plan, or an IRA are generally subject to income tax withholding unless the recipient elects otherwise. An eligible rollover distribution from a qualified retirement or annuity plan, 403(b) annuity, or governmental 457 plan is subject to income tax withholding at a 20-percent rate unless the distribution is rolled over to another plan, annuity or IRA by means of a direct transfer. Any distribution is an eligible rollover distribution unless specifically excepted from the definition. Exceptions to the definition of eligible rollover include a distribution that is part of a series of substantially equal periodic payments made at least annually for the life of the employee.

Loans from retirement plans

An individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated.

Subject to certain exceptions, a loan from a qualified employer plan to a plan participant is treated as a taxable distribution of plan benefits. A qualified employer plan includes a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-deferred annuity under section 403(b), and any plan that was (or was determined to be) a qualified employer plan or a governmental plan.

An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of: (1) $50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made; or (2) the greater of $10,000 or one half of the participant's accrued benefit under the plan.[284] This exception applies only if the loan is required, by its terms, to be repaid within five years. An extended repayment period is permitted for the purchase of the principal residence of the participant. Plan loan repayments (principal and interest) must be amortized in level payments and made not less frequently than quarterly, over the term of the loan.

Plan amendments

Present law provides a remedial amendment period during which, under certain circumstances, plan amendments may be retroactively effective in order for the plan to comply

[284] Sec. 72(p).

with the qualification requirements.[285] In general, plan amendments required to reflect changes in the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The Secretary may extend the time by which plan amendments need to be made.

<u>Use of retirement funds related to disaster relief for Hurricanes Katrina, Rita, and Wilma</u>

<u>In general</u>

Section 1400Q provides exceptions to certain rules regarding distributions from retirement plans, for loans from retirement plans, and for plan amendments to retirement plans.[286]

<u>Tax favored withdrawals from retirement plans</u>

Section 1400Q(a) provides an exception to the 10-percent early withdrawal tax in the case of a qualified hurricane distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA. In addition, as discussed more fully below, income attributable to a qualified hurricane distribution may be included in income ratably over three years, and the amount of a qualified hurricane distribution may be recontributed to an eligible retirement plan within three years.

A qualified hurricane distribution includes certain distributions from an eligible retirement plan related to Hurricanes Katrina, Wilma, and Rita. Specifically, qualified hurricane distributions include the following distributions from an eligible retirement plan: any distribution made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss by reason of Hurricane Katrina; any distribution made on or after September 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita; and any distribution made on or after October 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma.

The total amount of qualified hurricane distributions that an individual can receive from all plans, annuities, or IRAs is $100,000. Thus, any distributions in excess of $100,000 during the applicable periods are not qualified hurricane distributions.

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[285] Sec. 401(b).

[286] The relief with respect to Hurricane Katrina was initially provided in the Katrina Emergency Relief Act of 2005 (Pub. L. 109-73). The IRS provided guidance on those relief provisions in Notice 2005-92, 2005-2 C.B. 1165. The relief was codified in section 1400Q and was expanded to the Hurricanes Rita and Wilma Disaster areas in the Gulf Opportunity Zone Act of 2005 (Pub. L. 109-135).

Any amount required to be included in income as a result of a qualified hurricane distribution is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have ratable inclusion apply.

Any portion of a qualified hurricane distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. Any amount recontributed within the three-year period is treated as a rollover and thus is not includible in income. For example, if an individual receives a qualified hurricane distribution in 2005, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent early withdrawal tax. If, in 2007, the amount of the qualified hurricane distribution is recontributed to an eligible retirement plan, the individual may file an amended return (or returns) to claim a refund of the tax attributable to the amount previously included in income. In addition, if, under the ratable inclusion provision, a portion of the distribution has not yet been included in income at the time of the contribution, the remaining amount is not includible in income.

A qualified hurricane distribution is a permissible distribution from a 401(k) plan, 403(b) annuity, or governmental 457 plan, regardless of whether a distribution would otherwise be permissible. A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified hurricane distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer's controlled group does not exceed $100,000. A plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of $100,000, taking into account distributions from plans of other employers or IRAs.

Qualified hurricane distributions are subject to the income tax withholding rules applicable to distributions other than eligible rollover distributions. Thus, 20-percent mandatory withholding does not apply.

<u>Recontributions of withdrawals for home purchases</u>

Section 1400Q(b) generally provides that a distribution received from a 401(k) plan, 403(b) annuity, or IRA in order to purchase a home in the Hurricane Katrina, Rita, or Wilma disaster areas may be recontributed to such a plan, annuity, or IRA in certain circumstances.

The ability to recontribute applies to an individual who receives a qualified distribution. A qualified distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA, that is a qualified Katrina distribution, a qualified Rita distribution, or a qualified Wilma distribution.

A qualified Katrina distribution is a distribution: (1) that is received after February 28, 2005, and before August 29, 2005; and (2) that was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but only if the residence is not purchased or constructed on account of Hurricane Katrina. Any portion of a qualified Katrina distribution may, during the period beginning on August 25, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

A qualified Hurricane Rita distribution is a distribution: (1) that is received after February 28, 2005, and before September 24, 2005; and (2) that was to be used to purchase or construct a principal residence in the Hurricane Rita disaster area, but only if the residence is not purchased or constructed on account of Hurricane Rita. Any portion of a qualified Hurricane Rita distribution may, during the period beginning on September 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

A qualified Hurricane Wilma distribution is a distribution: (1) that is received after February 28, 2005, and before October 24, 2005; and (2) that was to be used to purchase or construct a principal residence in the Hurricane Wilma disaster area, but only if the residence is not purchased or constructed on account of Hurricane Wilma. Any portion of a qualified Hurricane Wilma distribution may, during the period beginning on October 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

Any amount recontributed is treated as a rollover. Thus, that portion of the qualified distribution is not includible in income (and also is not subject to the 10-percent early withdrawal tax).

<u>Loans from qualified plans to individuals sustaining an economic loss</u>

Section 1400Q(c) provides an exception to the income inclusion rule for loans from a qualified employer plan related to Hurricanes Katrina, Rita, and Wilma made to a qualified individual during an applicable period and provides a repayment delay for loans that are outstanding on or after a qualified beginning date if the due date for any repayment with respect to such loan occurs after the qualified beginning date and December 31, 2006.

The exception to the general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of: (1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made; or (2) the greater of $10,000 or the participant's accrued benefit under the plan.

In the case of a qualified individual with an outstanding loan on or after the qualified beginning date from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning on the qualified beginning date, and ending on December 31, 2006, such due date is delayed for one year. Any subsequent repayments with respect to such loan are required to be appropriately adjusted to reflect the delay in the due date and any interest accruing during such delay. The period during which required repayment is delayed is disregarded in complying with the requirements that the loan be repaid within five years and that level amortization payments be made.

A qualified individual entitled to this plan loan relief includes a qualified Katrina individual, a qualified Rita individual, or a qualified Wilma individual. A qualified Hurricane Katrina individual is an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss by reason of

Hurricane Katrina. The qualified beginning date for a qualified Katrina individual is August 25, 2005, and the applicable period is the period beginning on September 24, 2005, and ending December 31, 2006.

A qualified Hurricane Rita individual is an individual whose principal place of abode on September 23, 2005, is located in a Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita. The qualified beginning date for a qualified Hurricane Rita individual is September 23, 2005, and the applicable period is the period beginning on September 23, 2005, and ending on December 31, 2006.

A qualified Hurricane Wilma individual is an individual whose principal place of abode on October 23, 2005, is located in a Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma. The qualified beginning date for a qualified Hurricane Wilma individual is October 23, 2005, and the applicable period is the period beginning on October 23, 2005, and ending on December 31, 2006.

An individual cannot be a qualified individual with respect to more than one hurricane.

Plan amendments relating to Hurricanes Katrina, Rita, and Wilma

Section 1400Q(d) permits certain plan amendments made pursuant to any provision in section 1400Q, or regulations issued thereunder, to be retroactively effective. If the plan amendment meets the requirements of section 1400Q, then the plan will be treated as being operated in accordance with its terms. In order for this treatment to apply, the plan amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2007, or such later date as provided by the Secretary. Governmental plans are given an additional two years in which to make required plan amendments. If the amendment is required to be made to retain qualified status as a result of the changes made by section 1400Q (or regulations promulgated thereunder), the amendment is required to be made retroactively effective as of the date on which the change became effective with respect to the plan, and the plan is required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to section 1400Q may be made retroactively effective as of the first day the plan is operated in accordance with the amendment. A plan amendment will not be considered to be made pursuant to section 1400Q (or regulations) if it has an effective date before the effective date of the provision (or regulations) to which it relates.

Midwest Disaster area

Use of retirement funds from retirement plans relating to the Midwest Disaster area

Section 702(d) of the Heartland Disaster Relief Act of 2008[287] provides relief similar to the relief provided in section 1400Q with respect to use of retirement funds in connection with the tornadoes and storms that occurred in the Midwest disaster area. In particular, under this

[287] Pub. L. 110-343.

relief, the rules for tax-favored withdrawals from retirement plans apply to qualified Recovery Assistance distributions[288] on or after the applicable disaster date and before January 1, 2010.[289]. The special rules for loans from qualified plans allowing an increased loan amount applies to loans that occur between the date of enactment of the Heartland Disaster Relief Act of 2008 and December 31, 2009, and the rules delaying repayment for one year apply to any payments due between the applicable disaster date and December 31, 2009. Finally, in order to be eligible for the relief for delayed plan amendments, the plan amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2010, or such later date as provided by the Secretary.

Midwestern disaster area and applicable disaster date

For purposes of the special rules use of retirement funds from retirement plans under the Heartland Disaster Relief Act of 2008, the "Midwestern disaster area" is defined as an area with respect to which a major disaster was declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act ("Stafford Act") by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin, and determined by the President to warrant individual or individual and public assistance from the Federal government under such Act with respect to damages attributable to such severe storms, tornados, or flooding.

The term "applicable disaster date" means, with respect to any Midwestern disaster area, the date on which the severe storms, tornados, or flooding giving rise to the Presidential declaration occurred.

Explanation of Provision

The provision applies the special rule for tax favored withdrawal from retirement plans to Recovery Assistance distributions on or after the applicable disaster date and before January 1, 2011. The special rules for loans from qualified plans allowing an increased loan amount applies to loans that occur between the date of enactment of the Heartland Disaster Relief Act of 2008 and December 31, 2010, and the rules delaying repayment for one year apply to any payments due between the applicable disaster date and December 31, 2010. In order to be eligible for the relief for delayed plan amendments, the plan amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2011, or such later date as provided by the Secretary.

[288] A qualified Recovery Assistance distribution is generally defined the same manner as a qualified hurricane distribution, except that it is a distribution with respect to the Midwest disaster area.

[289] Rules similar to the rules for recontributions of withdrawals for home purchases are also provided with respect to the Midwest disaster area.

Effective Date

The provision takes effect as if included in section 702(d)(10) of the Heartland Disaster Tax Relief Act of 2008.

12. Extend for one-year the special midwestern disaster area exclusion for certain cancellations of indebtedness (sec. 587 of the bill)

Present Law

In general

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain farm indebtedness, certain real property business indebtedness, and qualified principal residence indebtedness (secs. 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income (except for discharges of real property business indebtedness and qualified principal residence indebtedness), taxpayers generally exclude discharge of indebtedness from income but reduce tax attributes by the amount of the discharge of indebtedness. The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Present law generally requires "applicable entities" to file information returns with the IRS regarding any discharge of indebtedness in the amount of $600 or more (sec. 6050P). This requirement applies without regard to whether the debtor is subject to tax on the discharged indebtedness. The term "applicable entities" (as defined in sec. 6050P(c)(1) includes: (1) any financial institution (as described in section 581 (relating to banks) or section 591(a) (relating to savings institutions)); (2) any credit union; (3) any corporation that is a direct or indirect subsidiary of an entity described in (1) or (2) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; (4) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, certain other Federal executive agencies, and any successor or subunit of any of them; (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. section 3701(a)(4)); and (6) any other organization a significant trade or business of which is the lending of money. Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers generally is $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Special rule for Midwestern disaster area

This special rule provides that the gross income of a qualified individual does not include any amount which would otherwise be includible in gross income by reason of a discharge (in whole or in part) of nonbusiness debt if the indebtedness is discharged by an applicable entity. For these purposes, nonbusiness debt is any indebtedness other than indebtedness incurred in connection with a trade or business. The discharge of indebtedness relief allowed under this provision does not apply to any indebtedness to the extent that real property constituting security for such indebtedness is located outside the Midwestern disaster area. As under the present-law rules, the amount excluded from gross income under this provision reduces the tax attributes of the taxpayer.

A qualified individual is any natural person if the principal place of abode of such person at the time was located in the Midwestern disaster area and such person suffered economic loss by reason of Midwestern disaster. An applicable entity is defined as under present-law section 6050P(c)(1).

The "Midwestern disaster area" is defined as an area with respect to which a major disaster was declared by the President on or after May 20, 2008, and before August 1, 2008, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act ("Stafford Act") by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin, and determined by the President to warrant individual or individual and public assistance from the Federal government under such Act with respect to damages attributable to such severe storms, tornados, or flooding.

This provision does not apply to discharges made after December 31, 2009.

Explanation of Provision

The Act provides a one year extension (through 2010) of the cancellation of indebtedness income relief with respect to the Midwestern disaster area.

The provision does not apply to discharges made after December 31, 2010.

Effective Date

The provision applies to discharges made after December 31, 2009.

TITLE II − UNEMPLOYMENT INSURANCE, HEALTH, AND OTHER PROVISIONS

A. Extension and Improvement of Premium Assistance for COBRA Benefits (sec. 211 of the bill)

Present Law

In general

The Code contains rules that require certain group health plans to offer certain individuals ("qualified beneficiaries") the opportunity to continue to participate for a specified period of time in the group health plan ("continuation coverage") after the occurrence of certain events that otherwise would have terminated such participation ("qualifying events").[290] These continuation coverage rules are often referred to as "COBRA continuation coverage" or "COBRA," which is a reference to the acronym for the law that added the continuation coverage rules to the Code.[291]

Plans subject to COBRA

A group health plan is defined as a plan of, or contributed to by, an employer (including a self-employed person) or employee organization to provide health care (directly or otherwise) to the employees, former employees, the employer, and others associated or formerly associated with the employer in a business relationship, or their families.[292] A group health plan includes a self-insured plan. The term group health plan does not, however, include a plan under which substantially all of the coverage is for qualified long-term care services.

Qualifying events and qualified beneficiaries

A qualifying event that gives rise to COBRA continuation coverage includes, with respect to any covered employee, the following events which would result in a loss of coverage of a qualified beneficiary under a group health plan (but for COBRA continuation coverage): (1) death of the covered employee; (2) the termination (other than by reason of such employee's gross misconduct), or a reduction in hours, of the covered employee's employment; (3) divorce or legal separation of the covered employee; (4) the covered employee becoming entitled to

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[290] Sec. 4980B.

[291] The COBRA rules were added to the Code by the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272. The rules were originally added as Code sections 162(i) and (k). The rules were later restated as Code section 4980B, pursuant to the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647.

[292] The following types of group health plans are not subject to the Code's COBRA rules: (1) a plan established and maintained for its employees by a church or by a convention or association of churches which is exempt from tax under section 501 (a "church plan"); (2) a plan established and maintained for its employees by the Federal government, the government of any State or political subdivision thereof, or by any instrumentality of the foregoing (a "governmental plan"); and (3) a plan maintained by an employer that normally employed fewer than 20 employees on a typical business day during the preceding calendar year (a "small employer plan").

Medicare benefits under title XVIII of the Social Security Act; (5) a dependent child ceasing to be a dependent child under the generally applicable requirements of the plan; and (6) a proceeding in a case under the U.S. Bankruptcy Code commencing on or after July 1, 1986, with respect to the employer from whose employment the covered employee retired at any time.

A "covered employee" is an individual who is (or was) provided coverage under the group health plan on account of the performance of services by the individual for one or more persons maintaining the plan and includes a self-employed individual. A "qualified beneficiary" means, with respect to a covered employee, any individual who on the day before the qualifying event for the employee is a beneficiary under the group health plan as the spouse or dependent child of the employee. The term qualified beneficiary also includes the covered employee in the case of a qualifying event that is a termination of employment or reduction in hours.

Continuation coverage requirements

Continuation coverage that must be offered to qualified beneficiaries pursuant to COBRA must consist of coverage which, as of the time coverage is being provided, is identical to the coverage provided under the plan to similarly situated non-COBRA beneficiaries under the plan with respect to whom a qualifying event has not occurred. If coverage under a plan is modified for any group of similarly situated non-COBRA beneficiaries, the coverage must also be modified in the same manner for qualified beneficiaries. Similarly situated non-COBRA beneficiaries means the group of covered employees, spouses of covered employees, or dependent children of covered employees who (i) are receiving coverage under the group health plan for a reason other than pursuant to COBRA, and (ii) are the most similarly situated to the situation of the qualified beneficiary immediately before the qualifying event, based on all of the facts and circumstances.

The maximum required period of continuation coverage for a qualified beneficiary (i.e., the minimum period for which continuation coverage must be offered) depends upon a number of factors, including the specific qualifying event that gives rise to a qualified beneficiary's right to elect continuation coverage. In the case of a qualifying event that is the termination, or reduction of hours, of a covered employee's employment, the minimum period of coverage that must be offered to the qualified beneficiary is coverage for the period beginning with the loss of coverage on account of the qualifying event and ending on the date that is 18 months[293] after the date of the qualifying event. If coverage under a plan is lost on account of a qualifying event but the loss of coverage actually occurs at a later date, the minimum coverage period may be extended by the plan so that it is measured from the date when coverage is actually lost.

The minimum coverage period for a qualified beneficiary generally ends upon the earliest to occur of the following events: (1) the date on which the employer ceases to provide any group health plan to any employee, (2) the date on which coverage ceases under the plan by reason of a

[293] In the case of a qualified beneficiary who is determined, under Title II or XVI of the Social Security Act, to have been disabled during the first 60 days of continuation coverage, the 18 month minimum coverage period is extended to 29 months with respect to all qualified beneficiaries if notice is given before the end of the initial 18 month continuation coverage period.

failure to make timely payment of any premium required with respect to the qualified beneficiary, and (3) the date on which the qualified beneficiary first becomes (after the date of election of continuation coverage) either (i) covered under any other group health plan (as an employee or otherwise) which does not include any exclusion or limitation with respect to any preexisting condition of such beneficiary or (ii) entitled to Medicare benefits under title XVIII of the Social Security Act. Mere eligibility for another group health plan or Medicare benefits is not sufficient to terminate the minimum coverage period. Instead, the qualified beneficiary must be actually covered by the other group health plan or enrolled in Medicare. Coverage under another group health plan or enrollment in Medicare does not terminate the minimum coverage period if such other coverage or Medicare enrollment begins on or before the date that continuation coverage is elected.

Election of continuation coverage

The COBRA rules specify a minimum election period under which a qualified beneficiary is entitled to elect continuation coverage. The election period begins not later than the date on which coverage under the plan terminates on account of the qualifying event, and ends not earlier than the later of 60 days or 60 days after notice is given to the qualified beneficiary of the qualifying event and the beneficiary's election rights.

Notice requirements

A group health plan is required to give a general notice of COBRA continuation coverage rights to employees and their spouses at the time of enrollment in the group health plan.

An employer is required to give notice to the plan administrator of certain qualifying events (including a loss of coverage on account of a termination of employment or reduction in hours) generally within 30 days of the qualifying event. A covered employee or qualified beneficiary is required to give notice to the plan administrator of certain qualifying events within 60 days after the event. The qualifying events giving rise to an employee or beneficiary notification requirement are the divorce or legal separation of the covered employee or a dependent child ceasing to be a dependent child under the terms of the plan. Upon receiving notice of a qualifying event from the employer, covered employee, or qualified beneficiary, the plan administrator is then required to give notice of COBRA continuation coverage rights within 14 days to all qualified beneficiaries with respect to the event.

Premiums

A plan may require payment of a premium for any period of continuation coverage. The amount of such premium generally may not exceed 102 percent[294] of the "applicable premium" for such period and the premium must be payable, at the election of the payor, in monthly installments.

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[294] In the case of a qualified beneficiary whose minimum coverage period is extended to 29 months on account of a disability determination, the premium for the period of the disability extension may not exceed 150 percent of the applicable premium for the period.

The applicable premium for any period of continuation coverage means the cost to the plan for such period of coverage for similarly situated non-COBRA beneficiaries with respect to whom a qualifying event has not occurred, and is determined without regard to whether the cost is paid by the employer or employee. The determination of any applicable premium is made for a period of 12 months (the "determination period") and is required to be made before the beginning of such 12 month period.

In the case of a self-insured plan, the applicable premium for any period of continuation coverage of qualified beneficiaries is equal to a reasonable estimate of the cost of providing coverage during such period for similarly situated non-COBRA beneficiaries which is determined on an actuarial basis and takes into account such factors as the Secretary of Treasury prescribes in regulations. A self-insured plan may elect to determine the applicable premium on the basis of an adjusted cost to the plan for similarly situated non-COBRA beneficiaries during the preceding determination period.

A plan may not require payment of any premium before the day which is 45 days after the date on which the qualified beneficiary made the initial election for continuation coverage. A plan is required to treat any required premium payment as timely if it is made within 30 days after the date the premium is due or within such longer period as applies to, or under, the plan.

Other continuation coverage rules

Continuation coverage rules which are parallel to the Code's continuation coverage rules apply to group health plans under the Employee Retirement Income Security Act of 1974 ("ERISA").[295] ERISA generally permits the Secretary of Labor and plan participants to bring a civil action to obtain appropriate equitable relief to enforce the continuation coverage rules of ERISA, and in the case of a plan administrator who fails to give timely notice to a participant or beneficiary with respect to COBRA continuation coverage, a court may hold the plan administrator liable to the participant or beneficiary in the amount of up to $110 a day from the date of such failure.

Although the Federal government and State and local governments are not subject to the Code and ERISA's continuation coverage rules, other laws impose similar continuation coverage requirements with respect to plans maintained by such governmental employers.[296] In addition, many States have enacted laws or promulgated regulations that provide continuation coverage rights that are similar to COBRA continuation coverage rights in the case of a loss of group

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[295] Secs. 601 to 608 of ERISA.

[296] Continuation coverage rights similar to COBRA continuation coverage rights are provided to individuals covered by health plans maintained by the Federal government. 5 U.S.C. sec. 8905a. Group health plans maintained by a State that receives funds under Chapter 6A of Title 42 of the United States Code (the Public Health Service Act) are required to provide continuation coverage rights similar to COBRA continuation coverage rights for individuals covered by plans maintained by such State (and plans maintained by political subdivisions of such State and agencies and instrumentalities of such State or political subdivision of such State). 42 U.S.C. sec. 300bb-1.

health coverage. Such State laws, for example, may apply in the case of a loss of coverage under a group health plan maintained by a small employer.

COBRA coverage assistance under the American Recovery and Reinvestment Act of 2009

Under the American Recovery and Reinvestment Act of 2009 ("ARRA"),[297] as amended by the Department of Defense Appropriations Act, 2010 ("DOD Act")[298] and the Temporary Extension Act of 2010 ("TEA"),[299] an assistance eligible individual is treated as having paid any premium required for COBRA continuation coverage under a group health plan if the individual pays 35 percent of the premium.[300] Thus, if the assistance eligible individual pays 35 percent of the premium, the group health plan must treat the individual as having paid the full premium required for COBRA continuation coverage, and the individual is entitled to a subsidy for 65 percent of the premium. Premium assistance is available for a period not to exceed 15 months.[301]

An assistance eligible individual is any qualified beneficiary: (1) who is eligible for COBRA continuation coverage because of a qualifying event that occurred between September 1, 2008, and March 31, 2010;[302] (2) who elects COBRA coverage; and (3) for whom the qualifying event was the employee's involuntary termination of employment, including an involuntary termination of employment occurring on or after TEA's date of enactment that follows a reduction in hours of employment (as described in more detail below).

An assistance eligible individual can be any qualified beneficiary associated with the relevant covered employee (e.g., a dependent of an employee who is covered immediately prior to a qualifying event), and such qualified beneficiary can independently elect COBRA and independently receive a subsidy. Thus, the subsidy for an assistance eligible individual continues after an intervening death of the covered employee.

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[297] Pub. L. No. 111-5.

[298] Pub. L. No. 111-118.

[299] Pub. L. No. 111-144.

[300] For this purpose, payment by an assistance eligible individual includes payment by another individual paying on behalf of the individual, such as a parent or guardian, or an entity paying on behalf of the individual, such as a State agency or charity. Further, the amount of the premium used to calculate the reduced premium is the premium amount that the employee would be required to pay for COBRA continuation coverage absent this premium reduction (e.g. 102 percent of the "applicable premium" for such period).

[301] Under ARRA, the premium assistance period was limited to a maximum of nine months. The DOD Act extended the maximum premium assistance period by six months to 15 months.

[302] Under ARRA, the event must have occurred prior to December 31, 2009. The DOD Act extended the date prior to which the event must have occurred to February 28, 2010 and TEA further extended the date prior to which the event must have occurred to March 31, 2010.

If the premium subsidy is provided with respect to any COBRA continuation coverage which covers the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer[303] during a taxable year and the taxpayer's modified adjusted gross income exceeds $145,000 (or $290,000 for joint filers),[304] then the amount of the premium subsidy for all months during the taxable year must be repaid. For taxpayers with adjusted gross income between $125,000 and $145,000 (or $250,000 and $290,000 for joint filers), the amount of the premium subsidy for the taxable year that must be repaid is reduced proportionately. The mechanism for repayment is an increase in the taxpayer's income tax liability for the year equal to such amount. An individual may permanently waive the right to the premium subsidy for all periods of coverage, allowing an assistance eligible individual who is certain that the modified adjusted gross income limit prevents the individual from being entitled to any premium subsidy for any coverage period to decline the subsidy for all coverage periods and avoid being subject to the recapture tax.

The assistance eligible individual's eligibility for the subsidy terminates with the first month beginning on or after the earlier of: (1) the date which is 15 months after the first day of the first day of coverage to which the subsidy applies,[305] (2) the end of the maximum required period of continuation coverage for the qualified beneficiary under the Code's COBRA rules or the relevant State or Federal law (or regulation), or (3) the date that the assistance eligible individual becomes eligible for Medicare benefits under title XVIII of the Social Security Act or health coverage under another group health plan (including, for example, a group health plan maintained by the new employer of the individual or a plan maintained by the employer of the individual's spouse).

Continuation coverage that qualifies for the subsidy is not limited to coverage required to be offered under the Code's COBRA rules but also includes continuation coverage required under State law that requires continuation coverage comparable to the continuation coverage required under the Code's COBRA rules for group health plans not subject to those rules (e.g., a small employer plan) and includes continuation coverage requirements that apply to health plans maintained by the Federal government or a State government. The cost of coverage under any group health plan that is subject to the Code's COBRA rules (or comparable State requirements or continuation coverage requirement under health plans maintained by the Federal government or any State government) is eligible for the subsidy, except contributions to a health flexible spending account offered under a cafeteria plan within the meaning of section 125 of the Code.

The notice of COBRA continuation coverage that a plan administrator is required to provide to qualified beneficiaries with respect to a qualifying event must contain additional

[303] Within the meaning of section 152 of the Code, determined without regard to sections 152(b)(1), (b)(2) and (d)(1)(B).

[304] Modified adjusted gross income for this purpose means adjusted gross income as defined in section 62 of the Code increased by any amount excluded from gross income under section 911, 931, or 933 of the Code.

[305] TEA clarified that, in determining when an assistance eligible individual's eligibility for the COBRA subsidy terminates, the relevant date is the date which is 15 months after the first day of coverage to which the subsidy applies, rather than the date which is 15 months after the first day of the first month for which the subsidy applies.

information including, for example, information about the qualified beneficiary's right to the premium reduction (and subsidy) and the conditions placed on eligibility for the subsidy. An updated notice is required to be provided to certain individuals who were already provided a COBRA election notice that did not include information regarding the changes made to the COBRA coverage assistance provisions of ARRA by the DOD Act. The Department of Labor has created model notices to assist plan administrators in complying with the notice requirements of ARRA, as amended by the DOD Act.

An individual may request review of a denial of treatment as an assistance eligible individual by a group health plan under an expedited 15-day review process by the Secretary of Labor or the Secretary of Health and Human Services (in consultation with the Secretary of the Treasury). TEA amended the expedited review process for denials of treatment as an assistance eligible individual to provide that, in addition to civil actions that may be brought to enforce applicable provisions of ERISA or other laws, the Secretary of Labor or Health and Human Services or an affected individual may bring a civil action to enforce a determination of an individual's eligibility and for appropriate relief. The Secretary of Labor or Health and Human Services may also assess a penalty against a plan sponsor or health insurance issuer of not more than $110 per day for each failure to comply with a determination of an individual's eligibility after 10 days after the date the plan sponsor or health insurance issuer receives the determination.

ARRA provides special rules for the reimbursement of an assistance eligible individual who pays 100 percent of the premium required for COBRA continuation coverage for the first period of COBRA continuation coverage to which the subsidy applies or the immediately subsequent period. The person who receives who receives the full premium amount is permitted to provide a credit to the assistance eligible individual for the amount overpaid against one or more subsequent premiums (at the reduced rate of 35 percent) for COBRA continuation coverage, but only if it is reasonable to believe that the credit for the excess will be used by the assistance eligible individual within 180 days of the individual's overpayment. Otherwise, the person must make a reimbursement payment to the individual for the amount of the premium overpayment within 60 days of receiving the overpayment. Further, if, as of any day within the 180-day period, it is no longer reasonable to believe that the credit will be used during that period by the assistance eligible individual (e.g., the individual ceases to be eligible for COBRA continuation coverage), payment equal to the remainder of the credit outstanding must be made to the individual within 60 days of such day.

Expansion of eligibility for COBRA subsidy under TEA

TEA expanded eligibility for the COBRA subsidy to include individuals who experience a loss of coverage on account of a reduction in hours of employment followed by the involuntary termination of employment of the covered employee. For an individual entitled to COBRA because of a reduction in hours and who is then subsequently involuntarily terminated from employment, the termination is considered a qualifying event for purposes of the COBRA subsidy, as long as the termination occurs during the period beginning on the date following TEA's date of enactment and ending on March 31, 2010. The assistance eligible individual's continuation coverage is determined as though the qualifying event was the reduction in hours of employment; however, the subsidy is only available for the period following the individual's actual termination of employment. TEA requires a plan administrator to provide such individuals with an additional notice of COBRA continuation coverage during the 60-day period beginning on the date of the individual's involuntary termination.

Retroactive reduced premium payments

Prior to enactment of the DOD Act an assistance eligible individual could receive a COBRA subsidy for a maximum of nine months. The DOD Act extended the maximum premium assistance period by six months, so that individuals could receive a total of 15 months of COBRA subsidy. Under the DOD Act assistance eligible individuals in a "transition period" who have ceased paying their COBRA premiums are permitted to retroactively pay their premiums (at the reduced rate of 35 percent) and receive the additional months of subsidized COBRA coverage. Retroactive payments are considered timely (and thus, the individual is considered to have been continuously covered) if: (1) the individual was covered under COBRA continuation coverage for the period immediately preceding the transition period; and (2) payments are made by the latest of February 17, 2010 (60 days after the date of enactment of the DOD Act), 30 days after the date the provision of the notice required by the DOD Act (as discussed below), or the end of the 30-day (or longer) grace period for making COBRA premium payments. A transition period is any period, beginning before the DOD Act's date of enactment, for which an individual is assistance eligible solely because of the changes made by the DOD Act. Thus, if an individual ceased paying COBRA premiums because they had exhausted their nine months of ARRA subsidies, or they did not elect COBRA coverage because their involuntary termination of employment occurred after December 31, 2009 (and so they would not have been eligible for subsidies under ARRA as originally enacted), they have the ability to retroactively pay their COBRA premiums.

Plan administrators are required to provide assistance eligible individuals in a DOD Act transition period notice of the extension of the maximum premium assistance period and their ability to make retroactive reduced premium payments within 60 days of the first day of their transition period.

Explanation of Provision

The provision extends the period during which an involuntary termination that is a qualifying event (including an involuntary termination of employment occurring on or after TEA's date of enactment that follows a reduction in hours of employment) must occur by nine months (from March 31, 2010 to December 31, 2010).

Under the provision, assistance eligible individuals in a "2010 transition period" who experience an involuntary termination that is a qualifying event on or after April 1, 2010, and prior to the provision's date of enactment, are permitted to retroactively pay their premiums (at the reduced rate of 35 percent) and maintain their COBRA coverage. Retroactive payments are considered timely (and thus, the individual is considered to have been continuously covered) if payments are made by the latest of 60 days after the date of enactment of the provision, 30 days after the date the provision of the notice required by the provision (as described below), or the end of the plan's grace period for making COBRA premium payments. An assistance eligible individual is in a "2010 transition period" if the he or she experienced an involuntary termination of employment that was a qualifying event prior to the date of enactment of the provision and he or she is eligible for the subsidy on account of the provision's extension of the period during which the qualifying event must occur.

In the case of an assistance eligible individual who pays 100 percent of the premium required for COBRA continuation coverage during a 2010 transition period, rules similar to the ARRA special reimbursement rules apply. These rules provide for the reimbursement of an assistance eligible individual, or the crediting of overpayments against future premium payments.

Plan administrators are required to provide assistance eligible individuals in a 2010 transition period notice of their ability to make retroactive reduced premium payments within 60 days of the first day of their transition period.

Effective Date

In general, the provision is effective as if included in the American Recovery and Reinvestment Act of 2009.

B. Refunds Disregarded in the Administration of Federal Programs and Federally-Assisted Programs (sec. 242 of the bill and new sec. 6409 of the Code)

Present Law

The Code does not provide an explicit uniform rule regarding the treatment of tax refunds for purposes of determining eligibility for benefits under Federal programs (or State or local programs financed with Federal funds).

Explanation of Provision

The provision excludes any tax refund (or advance payment with respect to a refundable tax credit) made to an individual from consideration as (i) income and (ii) resources for a period of 12 months from receipt for purposes of determining any individual's eligibility for benefits or assistance, including in amount or extent, under any Federal program or under any Federally-assisted State or local program.

Effective Date

The provision applies to amounts received after December 31, 2009. The provision does not apply to amounts received after December 31, 2010.

TITLE III − PENSION FUNDING RELIEF

A. Single Employer Plans

1. Extended period for single-employer defined benefit plans to amortize certain shortfall amortization bases (sec. 301 of the bill and sec. 430 of the Code)

<u>**Present Law**</u>

<u>**Minimum funding rules**</u>

<u>In general</u>

Defined benefit pension plans generally are subject to minimum funding rules that require the sponsoring employer to periodically make contributions to fund plan benefits.[306] The minimum funding rules for single-employer defined benefit pension plans were substantially revised by the Pension Protection Act of 2006 ("PPA").[307] The PPA also revised the funding rules that apply to multiemployer defined benefit pension plans. The Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA")[308] made a number of technical corrections to the PPA. In addition, WRERA made certain amendments to the PPA minimum funding rules to provide funding relief to defined benefit plans affected by the decline in global financial markets during 2008.

The PPA minimum funding rules are generally effective for plan years beginning after December 31, 2007. Delayed effective dates apply to single-employer plans sponsored by certain large defense contractors, multiple employer plans of some rural cooperatives, and single-

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[306] Sec. 412. Similar rules apply to defined benefit pension plans under the Labor Code provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). A number of exceptions to the minimum funding rules apply. For example, governmental and church plans are not subject to the minimum funding rules. Under section 414(d), a governmental plan is generally a plan established and maintained for its employees by the Federal government, a State government or political subdivision, or an agency or instrumentality of the foregoing. A governmental plan also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act and any plan of an international organization that is exempt from taxation by reason of the International Organizations Immunities Act. A governmental plan includes a plan established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, so long as all participants are employees of such entity, substantially all of whose services as employees are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function). Under section 414(e), a church plan is a plan established and maintained for its employee by a church or by a convention or association of churches which is exempt from tax under section 501. A church plan may elect to be subject to the minimum funding rules.

[307] Pub. L. No. 109-280.

[308] Pub. L. No. 110-458.

employer plans affected by settlement agreements with the Pension Benefit Guaranty Corporation ("PBGC").[309]

The minimum funding rules for single-employer and multiemployer plans are different. A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement. There are also multiple employer plans, which are plans maintained by more than one employer and to which more than one employer is required to contribute, but that are not maintained pursuant to a collective bargaining agreement. The single-employer plan funding rules generally apply to multiple employer plans.

The purpose of the minimum funding rules is to ensure that the sponsoring employer of a defined benefit pension plan makes periodic minimum contributions that will adequately fund benefits promised under the plan. The rules permit an employer to fund the plan over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan.

The due date for the payment of a minimum required contribution for a plan year is generally eight and one-half months after the end of the plan year.[310] If unpaid minimum funding contributions for a single-employer plan exceed $1,000,000, a lien arises in favor of the plan upon all property and rights to property (real or personal) belonging to the sponsoring employer (or member of the sponsoring employer's controlled group) in an amount equal to the unpaid minimum contributions.[311] Notice must be given to the PBGC[312] of a funding failure that gives rise to a lien, and generally the lien is enforceable by the PBGC.

In the event of a failure to comply with the minimum funding rules, the Code imposes a two-level excise tax on the plan sponsor.[313] The initial tax is 10 percent of aggregate unpaid contributions for single-employer plans and five percent of the plan's accumulated funding deficiency (as defined below) for multiemployer plans. An additional tax is imposed if the

[309] The PPA funding rules do not apply to eligible government contractor plans for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan, (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule, and (3) January 1, 2011. The new funding rules do not apply to eligible rural cooperative plans for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan, or (2) January 1, 2017. The new funding rules do not apply to eligible PBGC settlement plans for plan years beginning before January 1, 2014.

[310] Sec. 430(j).

[311] Sec. 430(k).

[312] The PBGC was established for the purpose of ensuring that benefits promised under a defined benefit pension plan are paid (up to specified annual limits) if the sponsoring employer is not able to fulfill its obligation to adequately fund the plan and the plan is terminated when it is underfunded. ERISA sec. 4002(a). The benefit protection function of the PBGC is carried out through an insurance program that applies to defined benefit pension plans. Sponsors of plans that are subject to the insurance program are liable to the PBGC for premium payments. PBGC termination insurance serves as a backstop to the minimum funding rules.

[313] Sec. 4971.

failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the Internal Revenue Service ("IRS") or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

Funding target and shortfall amortization charges

The minimum required contribution for a plan year for single-employer defined benefit plans generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost.[314] The plan's funding target for a plan year is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or to be earned during the plan year. WRERA clarified that a plan's target normal cost is increased by the amount of plan-related expenses expected to be paid from plan assets during the plan year, and is decreased by the amount of mandatory employee contributions expected to be made to the plan during the plan year.[315]

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year.[316] In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. The shortfall amortization base for a plan year is: (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases for preceding plan years.

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[314] Sec. 430.

[315] This clarification is effective for plan years beginning after December 31, 2008, and is elective for the preceding plan year. Final regulations issued under section 430 reserve the issue of the definition of "plan-related expenses". The definition of the term is expected to be the subject of future proposed regulations. Treas. Reg. sec. 1.430(d)-1(b)(2)(iii)(B).

[316] Under a special rule, a shortfall amortization base does not have to be established for a plan year if the value of a plan's assets is at least equal to the plan's funding target for the plan year. For purposes of the special rule, a transition rule applies for plan years beginning after 2007 and before 2011. The transition rule does not apply to a plan that (1) was not in effect for 2007, or (2) was subject to certain deficit reduction contribution rules for 2007 (i.e., a plan covering more than 100 participants and with a funded current liability below a specified threshold). Under the transition rule, a shortfall amortization base does not have to be established for a plan year during the transition period if the value of plan assets for the plan year is at least equal to the applicable percentage of the plan's funding target for the year. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. While the PPA provided that the transition rule did not apply to a plan for any plan year after 2008 unless, for each preceding plan year after 2007, the plan's shortfall amortization base was zero (i.e., the plan was eligible for the special rule each preceding year), WRERA amended the PPA rules to extend the transition rule to plan years beginning after 2008 even if, for each preceding plan year after 2007, the plan's shortfall amortization base was not zero.

As a result, in any given plan year, a plan may have a number of shortfall amortization installments that relate to the current or prior years. The aggregate of these installments is referred to as the shortfall amortization charge. In the case of a plan with a funding shortfall for a plan year, the minimum required contribution is generally equal to the sum of the plan's target normal cost and the shortfall amortization charge for that year.

A shortfall amortization base may be positive or negative, depending on whether the present value of remaining installments with respect to prior year amortization bases is more or less than the plan's funding shortfall. In either case, the shortfall amortization base is amortized over a seven-year period beginning with the current plan year. Shortfall amortization installments for a particular plan year with respect to positive and negative shortfall amortization bases are netted in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero (i.e., negative amortization installments may not offset normal cost).

If the value of the plan's assets exceeds the plan's funding target for a plan year, then the minimum required contribution is generally equal to the plan's target normal cost for the year. Target normal cost for this purpose is reduced (but not below zero) by the amount by which the value of the plan's assets exceed the plan's funding target.

Actuarial assumptions

The minimum funding rules for single-employer defined benefit pension plans specify the interest rates and other actuarial assumptions that must be used in determining a plan's target normal cost and funding target. Under the rules, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.

The present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date. An election of a preceding month applies to the plan year for which it is made and all succeeding plan years unless revoked with the consent of the Secretary.

Solely for purposes of determining minimum required contributions, in lieu of the segment rates described above, a plan sponsor may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (i.e., without regard to the 24-month averaging described above) ("spot" rates). In general, such an election may be revoked only with approval of the Secretary. However, Treasury regulations provide automatic approval for plan sponsors to make a new choice of interest rates for 2009 and 2010 (regardless of what choices were made for earlier years).[317] In addition, for 2009, the IRS has indicated that it will allow plan sponsors to use the spot rate for the month that includes the plan's valuation date for the 2009 plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date (rather than only for the month preceding the valuation date).[318]

Explanation of Provision

Election of extended amortization period

The provision permits the plan sponsor of a single-employer defined benefit pension plan to elect to determine the shortfall amortization installments with respect to the shortfall amortization base for not more than two eligible plan years under two alternative extended amortization schedules.

Under the provision, the sponsor of a single-employer defined benefit plan may elect to amortize the shortfall amortization base for an eligible plan year over a nine-year period beginning with the election year ("two plus seven amortization schedule"). The shortfall amortization installments for the first two plan years in the nine-year period are equal to the interest on the shortfall amortization base for the election year, determined by using the effective interest rate for the election year.[319] The shortfall amortization installments for the last seven plan years in the nine-year period are equal to the amounts necessary to amortize the remaining balance of the shortfall amortization base for the election year in level annual installments over the seven-year period, determined by using the segment rates for the election year.

Alternatively, the sponsor of a single-employer defined benefit plan may elect to amortize the shortfall amortization base for an election year in level annual installments over a fifteen-year period beginning with the election year ("fifteen-year amortization schedule").

For purposes of the provision, an eligible plan year is a plan year beginning in 2008, 2009, 2010, or 2011, but only if the due date for the payment of the minimum required

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[317] Treas. Reg. sec. 1.430(h)(2)-1(h)(3). Final regulations under sections 430(d), 430(f), 430(g), 430(h)(2), 430(i) and 436 were issued on October 7, 2009 and published in the Federal Register on October 15, 2009. 74 F.R. 53004 (October 15, 2009). The regulations are effective for plan years beginning on or after January 1, 2010, except for plans to which a delayed effective date applies. For plan years beginning before January 1, 2010, plans are permitted to rely on the final regulations or the proposed regulations (72 F.R. 74215) for purposes of satisfying the requirements of sections 430 and 436.

[318] Internal Revenue Service, Employee Plans News, March 2009 Special Edition.

[319] The effective interest rate with respect to a plan for a plan year is the single rate of interest which, if used to determine the present value of the benefits taken into account in determining the plan's funding target for the year, would result in an amount equal to the plan's funding target (as determined using the first, second, and third segment rates). Sec. 430(h)(2)(A).

contribution for the plan year occurs on or after the date of enactment of the provision. A plan sponsor is not required to elect to use an extended amortization schedule for more than one eligible plan year or to make such election for consecutive eligible plan years; however, a plan sponsor who does make an election for two eligible plan years is required to elect the same extended amortization schedule for each year. For example, a plan sponsor who elects to use the fifteen-year amortization schedule for the plan year beginning in 2009 can make an election to use that same extended amortization schedule for the plan year beginning in 2010 or 2011; however, the plan sponsor is not permitted to elect the two plus seven amortization schedule for either of those subsequent eligible plan years.

Multiple employer plans of rural cooperatives that are not yet subject to the PPA minimum funding rules may only elect an extended amortization schedule for the plan year beginning in 2011.

An election to use an extended amortization schedule may be revoked only with the consent of the Secretary. Prior to granting a revocation request the Secretary must provide the PBGC an opportunity to comment on the conditions applicable to the treatment of any portion of the election year shortfall amortization base that remains unamortized as of the revocation date.

Increase in required installments for certain plans

In general

Under the provision, any plan year in a restriction period is a year in which the shortfall amortization installment otherwise determined and payable for that year pursuant to an election to use an extended amortization period may be increased, subject to certain limits described below, by an "installment acceleration amount". The length of the restriction period following an election to use an extended amortization schedule depends on the extended amortization schedule elected by the plan sponsor for the eligible plan year. For a plan sponsor who elects to use the two plus seven amortization schedule for an eligible plan year, the restriction period is the three year period beginning with the election year or, if later, the first plan year beginning after December 31, 2009. For a plan sponsor who elects to use the fifteen-year amortization schedule for an eligible plan year, the restriction period is the five year period beginning with the election year or, if later, the first plan year beginning after December 31, 2009.

For example, for a plan sponsor who elects to use the two plus seven amortization schedule for the plan year beginning in 2009, the restriction period with respect to that election is the three year period during the 2010, 2011 and 2012 plan years. If the same plan sponsor then elects to use the two plus seven amortization schedule for the plan year beginning in 2011, the separate restriction period with respect to that election is the three year period during the 2011, 2012 and 2013 plan years.

Installment acceleration amount

The "installment acceleration amount" with respect to any plan year in a restriction period is the aggregate amount of excess employee compensation with respect to all employees for the plan year and the aggregate amount of extraordinary dividends and redemptions for the plan year. For purposes of the provision, "plan sponsor" includes any member of the plan sponsor's controlled group (as determined for purposes of the minimum funding rules).

Excess employee compensation

Excess employee compensation is compensation (as defined below) with respect to any employee (including a self-employed individual treated as an employee under section 401(c)) for any plan year in excess of $1,000,000. Beginning in 2011, the $1,000,000 threshold is indexed to the Consumer Price Index for Urban Consumers, rounded to the next lowest $1,000.

For purposes of determining excess employee compensation, "compensation" includes all amounts attributable to services performed by an employee for a plan sponsor after February 28, 2010 that are includable in the employee's income as remuneration during the calendar year in which the plan year begins, regardless of whether the services were performed during such calendar year. Compensation for any employee during a calendar year also includes any amount that the plan sponsor directly or indirectly sets aside or reserves in, or transfers to, a trust (or other arrangement specified by the Secretary) during the calendar year for purposes of paying deferred compensation to the employee under a nonqualified deferred compensation plan (as defined in section 409A) of the plan sponsor, unless such amount is otherwise includable in income as remuneration by the employee in that calendar year. To the extent that an amount is taken into account when set aside, reserved or transferred to a trust or other arrangement, that amount is not taken into account in calculating the excess employee compensation with respect to the employee in any subsequent calendar year. The rule for amounts set aside, reserved or transferred to a trust or other arrangement applies without regard to whether the related compensation is attributable to services performed by an employee for a plan sponsor before or after February 28, 2010.

Compensation does not include any amount otherwise includable in the employee's income with respect to the granting of service recipient stock (as defined for purposes of section 409A) after February 28, 2010 that is, at the time of grant, subject to a substantial risk of forfeiture (within the meaning of section 83(c)(1)) for at least five years following the date of grant. A grant would not fail to satisfy this requirement if the grant were vested upon death, disability, or involuntary termination of employment before the end of the five-year period. Under the provision, the Secretary may provide for the application of this exception for restricted service recipient stock to persons other than corporations. In addition, compensation does not include any remuneration payable to an employee on a commission basis solely on account of income directly generated by that employee's individual performance. Finally, compensation does not include any remuneration consisting of nonqualified deferred compensation, restricted stock, restricted stock units, stock options, or stock appreciation rights payable or granted under a binding written contract in effect on March 1, 2010 and not modified in any material respect before the remuneration is paid.

Extraordinary dividends and redemptions

The aggregate amount of extraordinary dividends and redemptions for a plan year is equal to the amount by which the sum of the dividends declared during the plan year by the plan sponsor and the aggregate amount paid for the redemption of stock of the plan sponsor redeemed during the plan year exceeds the greater of (1) the plan sponsor's adjusted net income (within the meaning of section 4043 of ERISA) for the preceding plan year, determined without regard for any reduction by reason of interest, taxes, depreciation or amortization or (2) for a plan sponsor who determined and declared dividends in the same manner for at least five consecutive years immediately preceding the plan year, the aggregate amount of dividends determined and declared for the plan year in that manner. It is intended that dividends would be deemed to be determined in the same manner for the prior five years if they are at the same level or rate as dividends in the previous five consecutive years. For purposes of the provision, only dividends declared and redemptions occurring after February 28, 2010 are taken into account in determining the amount of dividends and redemptions for a plan year.

In calculating the dividends declared and amounts paid for the redemption of stock during the plan year, the following amounts are disregarded: (1) dividends paid by one member of the plan sponsor's controlled group to another member of the controlled group; (2) redemptions made pursuant to an employee benefit plan or that are made on account of the death, disability or termination of employment of an employee or shareholder; and (3) dividends and redemptions with respect to applicable preferred stock on which dividends accrue at a specified rate in all events and without regard to the plan sponsor's income and with respect to which interest accrues on any unpaid dividends. Applicable preferred stock is preferred stock originally issued before March 1, 2010 (including any preferred stock originally issued prior to that date that is subsequently reissued with otherwise identical terms) and preferred stock issued after March 1, 2010 that is held by an employee benefit plan subject to Title I of ERISA.

Limitations on installment acceleration amounts

Annual limitation

Under the provision, the installment acceleration amount for a plan year is limited to the aggregate amount of funding relief received by the plan sponsor in prior years as a result of an election to use an extended amortization period for an eligible plan year. To the extent that an installment acceleration amount is limited by application of this rule, the excess installment acceleration amount is generally carried over to the succeeding plan year.

Thus, under the provision, the installment acceleration amount for any plan year may not exceed the excess (if any) of (1) the sum of the shortfall amortization installments for that plan year and all prior plan years in the nine or fifteen year amortization period, as elected, with respect to the shortfall amortization base for the election year, that would have been determined and payable by the plan sponsor with respect to that shortfall amortization base in the absence of an election to use an extended amortization period over (2) the sum of the shortfall amortization installments for such plan years, determined under the two and seven or fifteen year amortization schedule, as elected by the plan sponsor, including any installment acceleration amount from a preceding plan year ("annual limit").

To the extent that a carryover of excess installment acceleration amounts from a preceding plan year, when added to other installment acceleration amounts for a plan year (as determined prior to application of the annual limit on installment acceleration amounts) would cause the shortfall amortization installment for the plan year to exceed the annual limit, the excess is similarly carried over to the next succeeding plan year. Under the provision, the following ordering rule applies in applying the annual limit for a plan year: the installment acceleration amounts for the plan year, determined prior to the addition of any carryover installment acceleration amount from a preceding year, is applied first against the annual limit and then any installment acceleration amounts carried over to the plan year are applied against the annual limit on a first-in, first-out basis.

The carryover rules apply during the restriction period with respect to an election year and for a limited number of years following the expiration of the restriction period with respect to an election year. Under the provision, no amount is carried over to a plan year that begins after the first plan year following the last plan year in the restriction period applicable to a two plus seven amortization schedule and no amount is carried over to a plan year that begins after the second plan year following the last plan year in the restriction period applicable to a fifteen year amortization schedule.

<u>Total installments limited to the present value of the shortfall amortization base</u>

Two additional rules (subject to rules prescribed by the Secretary) apply under the provision to insure that the addition of an installment acceleration amount to a shortfall amortization installment for a plan year results only in an acceleration of the payment of amounts that would otherwise be included in subsequent shortfall amortization installments with respect to the shortfall amortization base for the election year and not in the amortization of an amount in excess of that shortfall amortization base.

Under the first rule, if the shortfall amortization installment with respect to the shortfall amortization base for an election year is required to be increased by any installment acceleration amount, the remaining shortfall amortization installments with respect that shortfall amortization base are reduced, in reverse order of the otherwise required installments, to the extent necessary to limit the present value of the remaining installments to the present value of the remaining unamortized shortfall amortization base. Under the second rule, the increase for any plan year is limited to the amount that does not cause the amount of the installment to exceed the present value of the installment and all succeeding installments with respect to the shortfall amortization base for the election year (determined without regard to the installment acceleration amount, but after application of the first rule reducing the remaining shortfall amortization installments to reflect any installment acceleration amount).

Under the provision, any installment acceleration amount is disregarded for purposes of determining a plan's quarterly contributions.

<u>Reporting requirement</u>

The provision requires a plan sponsor who elects to use an extended amortization schedule is required to give notice of the election to participants and beneficiaries of the plan and to inform the PBGC of the election in such form and manner as the Director of the PBGC may require.

Regulations and guidance

The Secretary is directed to provide rules for the application of the provisions governing installment acceleration amounts to plan sponsors who elect an extended amortization schedule for two or more plans, including rules for the ratable allocation of any installment acceleration amount among electing plans on the basis of each plan's relative reduction in its shortfall amortization installment for the first plan year in the extended amortization period. The Secretary is also directed to provide rules for the application of those provisions and the provisions governing the election of an extended amortization schedule in any case where there is a merger or acquisition involving an electing plan sponsor.

Effective Date

The provision is effective for plan years beginning after December 31, 2007.

2. Application of extended amortization period to plans subject to prior law funding rules (sec. 302 of the bill)

Present Law

In general

Defined benefit pension plans generally are subject to minimum funding requirements under ERISA and the Code.[320] PPA made significant changes to the minimum funding requirements for single-employer plans. Generally, those modifications became effective for plan years beginning after December 31, 2007. As discussed below, however, there are delayed effective dates for certain plans including multiple employer plans of certain cooperatives, certain PBGC settlement plans, and plans of certain government contractors.

Multiple employer plans of certain cooperatives

Section 104 of PPA provides a delayed effective date for the PPA's single-employer plan funding rules for any plan that was in existence on July 26, 2005, and was an eligible cooperative plan for the plan year including that date. A plan is treated as an eligible cooperative plan for a plan year if it is maintained by more than one employer and at least 85 percent of the employers are: (1) certain rural cooperatives;[321] or (2) certain cooperative organizations that are more than

[320] Sec. 412 and sec. 302 of ERISA. Multiemployer defined benefit pension plans are also subject to the minimum funding requirements, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans. Governmental plans and church plans are generally exempt from the minimum funding requirements.

[321] This is as defined in Code section 401(k)(7)(B) without regard to (iv) thereof and includes (1) organizations engaged primarily in providing electric service on a mutual or cooperative basis, or engaged primarily in providing electric service to the public in its service area and which is exempt from tax or which is a State or local government, other than a municipality; (2) certain civic leagues and business leagues exempt from tax 80 percent of the members of which are described in (1); (3) certain cooperative telephone companies; and (4) any organization that is a national association of organizations described above.

50-percent owned by agricultural producers or by cooperatives owned by agricultural producers, or organizations that are more than 50-percent owned, or controlled by, one or more such cooperative organizations. A plan is also treated as an eligible cooperative plan for any plan year for which it is maintained by more than one employer and is maintained by a rural telephone cooperative association.

The PPA's funding rules do not apply with respect to an eligible cooperative plan for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan; or (2) January 1, 2017. In addition, in applying the pre-PPA funding rules to an eligible cooperative plan to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the PPA funding rules apply, the interest rate used is the interest rate applicable under the PPA funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the PPA funding rules).[322]

Certain PBGC settlement plans

The PPA provides a delayed effective date for its single-employer plan funding rules for any plan that was in existence on July 26, 2005, and was a "PBGC settlement plan" as of that date. The term "PBGC settlement plan" means a single-employer defined benefit plan: (1) that was sponsored by an employer in bankruptcy proceedings giving rise to a claim by the PBGC of not greater than $150 million, and the sponsorship of which was assumed by another employer (not a member of the same controlled group as the bankrupt sponsor) and the PBGC's claim was settled or withdrawn in connection with the assumption of the sponsorship; or (2) that, by agreement with the PBGC, was spun off from a plan subsequently terminated by the PBGC in an involuntary termination.

The PPA's funding rules do not apply with respect to a PBGC settlement plan for plan years beginning before January 1, 2014. In addition, in applying the pre-PPA funding rules to such a plan for plan years beginning after December 31, 2007, and before January 1, 2014, the interest rate used is the third segment rate under the PPA funding rules.

Plans of certain government contractors

The PPA provides a delayed effective date for its single-employer plan funding rules for any eligible government contractor plan. A plan is treated as an eligible government contractor plan if it is maintained by a corporation (or member of the same affiliated group): (1) whose

[322] PPA specifies the interest rates that must be used in determining a plan's target normal cost and funding target. Present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period.

primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition Regulations[323] and also to the Defense Federal Acquisition Regulation Supplement;[324] (2) whose revenue derived from such business in the previous fiscal year exceeded $5 billion; and (3) whose pension plan costs that are assignable under those contracts are subject to certain provisions of the Cost Accounting Standards.[325]

The PPA funding rules do not apply with respect to such a plan for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan; (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule;[326] and (3) the first plan year beginning after December 31, 2010. In addition, in applying the pre-PPA funding rules to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the PPA funding rules apply, the interest rate used is the third segment rate under the PPA funding rules.

General minimum funding rules for plans with delayed PPA effective dates

Funding standard account

As an administrative aid in the application of the pre-PPA funding requirements, a defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. Other charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments, experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan's actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

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[323] Chapter 1 of Title 48, C.F.R..

[324] Chapter 2 of Title 48, C.F.R..

[325] 48 C.F.R. 9904.412 and 9904.413.

[326] Section 106(d) of PPA requires the Cost Accounting Standards Board to review and revise sections 412 and 413 of the Cost Accounting Standards (48 C.F.R. 9904.412 and 9904.413) to harmonize the minimum required contributions under ERISA of eligible government contractor plans and government reimbursable pension plan costs, not later than Jan. 1, 2010. Any final rule adopted by the Cost Accounting Standards Board will be considered the Cost Accounting Standards Pension Harmonization Rule.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the plan's accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. The gain or loss for a year from changes in actuarial assumptions is amortized as credits or charges to the funding standard account over ten years.

If minimum required contributions are waived, the waived amount (referred to as a "waived funding deficiency") is credited to the funding standard account. The waived funding deficiency is then amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded.

If, as of the close of a plan year, the funding standard account reflects credits at least equal to charges, the plan is generally treated as meeting the minimum funding standard for the year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the funding standard account would exceed credits to the account if no contribution were made to the plan. For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

Funding methods and general concepts

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan: (1) in level dollar amounts; (2) as a uniform percentage of payroll; (3) as a uniform amount per unit of service (e.g., $1 per hour); or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. For example, the cost attributable to a past service liability is generally amortized over 30 years.

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefits under the plan, as described below).

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined on the basis of a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be determined if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.[327]

Additional contributions for underfunded plans with delayed PPA effective dates

In general

Under special funding rules (referred to as the "deficit reduction contribution" rules),[328] an additional charge to a plan's funding standard account is generally required for a plan year if

[327] Under present law, certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

[328] The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more

the plan's funded current liability percentage for the plan year is less than 90 percent.[329] A plan's "funded current liability percentage" is generally the actuarial value of plan assets as a percentage of the plan's current liability.[330] In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined on a present-value basis.

The amount of the additional charge required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below), over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits. The amount of the additional charge cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent (taking into account the expected increase in current liability due to benefits accruing during the plan year).

The deficit reduction contribution is generally the sum of: (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.[331] The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. For example, if a plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).[332]

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than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

[329] Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

[330] In determining a plan's funded current liability percentage for a plan year, the value of the plan's assets is generally reduced by the amount of any credit balance under the plan's funding standard account. However, this reduction does not apply in determining the plan's funded current liability percentage for purposes of whether an additional charge is required under the deficit reduction contribution rules.

[331] The deficit reduction contribution may also include an additional amount as a result of the use of a new mortality table prescribed by the Secretary of the Treasury in determining current liability for plan years beginning after 2006.

[332] In making these computations, the value of the plan's assets is reduced by the amount of any credit balance under the plan's funding standard account.

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit is not considered in determining additional contributions until the event has occurred. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

Explanation of Provision

In general

The provision offers two types of funding relief to underfunded plans with delayed PPA effective dates.[333] Under the provision a plan sponsor may elect either: (1) a two year look-back rule for purposes of calculating the plan's deficit reduction contribution; or (2) a 15-year amortization period for purposes of determining the plan's unfunded new liability.

Plan sponsors of eligible plans may elect relief for not more than two applicable years (one year for plans of certain government contractors). Plan sponsors electing two years of relief must elect the same type of relief for each year. Generally, relief may be elected for any two plan years beginning in 2008, 2009, 2010, or 2011. A plan year beginning in 2008 may be an applicable year, however, only if the due date for payment of the plan's minimum required contribution occurs on or after the provision's date of enactment. A plan sponsor is not required to make an election for more than one applicable plan year or to make such election for consecutive applicable plan years; however, a plan sponsor that does make an election for two plan years is required to elect the same relief provision for each year. For example, a plan sponsor that elects to use the two year look-back rule for the plan year beginning in 2009 can make an election to use that same rule for the plan year beginning in 2010 or 2011; however, the plan sponsor is not permitted to elect to use the 15-year amortization period for purposes of determining the plan's unfunded new liability for either of those subsequent eligible plan years. A "pre-effective date plan year" is any plan year prior to the first year to which the PPA funding rules apply to the plan.

The provision requires the Secretary of the Treasury to prescribe rules for making, and in appropriate circumstances revoking, elections. An election may be revoked only with the consent of the Secretary.

Look-back rule

The provision permits plan sponsors of underfunded plans with delayed PPA effective dates to elect to use a two year look-back for purposes of determining their deficit reduction contribution. That is, an eligible underfunded plan may elect to use a plan's funded current

[333] That is, multiple employer plans of certain cooperatives (as defined in section 104 of PPA), certain PBGC settlement plans (as defined in section 105 of PPA), and plans of certain government contractors (as defined in section 106 of PPA).

liability percentage from the second plan year preceding the plan's first election year under the provision.

In determining its deficit reduction contribution, a plan that elects to use the two-year lookback rule is permitted to use the third segment rate under the PPA funding rules[334] in calculating a portion of its unfunded new liability amount. Under the pre-PPA rules, the unfunded new liability amount is the applicable percentage of the plan's unfunded new liability. Under the provision, in calculating its unfunded new liability amount, an electing plan may use the PPA third segment rate as the applicable percentage rather than the pre-PPA applicable percentage (i.e., 30 percent decreased by .40 of one percentage point for each percentage point by which the plan's funded current liability exceeds 60 percent), but only with respect to the portion of the plan's unfunded new liability that is its "increased unfunded new liability". The electing plan continues to use the pre-PPA applicable percentage in calculating its unfunded new liability amount with respect to the excess of the unfunded new liability over the increased unfunded new liability. The increased unfunded new liability is the excess (if any) of the plan's unfunded new liability over the amount of unfunded new liability determined as if the value of the plan's assets equaled the product of the current liability of the plan for the year multiplied by the funded current liability percentage of the plan for the second plan year preceding the first election year of such plan.

<u>15-year amortization</u>

The provision permits plan sponsors of underfunded plans with delayed PPA effective dates to elect to use a special applicable percentage for purposes of calculating a portion of their unfunded new liability amount for any pre-effective date plan year beginning with or after the first election year. The special applicable percentage is the ratio of: (1) the annual installments payable in each year if the increased unfunded new liability for that plan year was amortized over 15 years, using an interest rate equal to the third segment rate under the PPA funding rules; to (2) the increased unfunded new liability for the plan year. This special applicable percentage applies with respect to the portion of the plan's unfunded new liability that is its increased unfunded new liability. The electing plan continues to use the pre-PPA applicable percentage in calculating its unfunded new liability amount with respect to the excess of the unfunded new liability over the increased unfunded new liability.

<u>Eligible charity plans</u>

The provision amends section 104 of PPA by making the section applicable to eligible charity plans. Under the provision, therefore, the delayed PPA effective date and special interest rates rules that apply to eligible cooperative plans apply to eligible charity plans. This provision was intended to allow plans of large national charities and their separately organized local chapters to have access to the relief whether or not they are treated as a single controlled group. An eligible charity plan that makes the election will not have violated the anti-cutback or other

[334] PPA secs. 104(b), 105(b), and 106(b). The third segment rate is derived from a corporate bond yield curve prescribed by the Secretary of the Treasury which reflects the yields on investment grade corporate bonds with varying maturities.

qualification requirements merely as a result of operating in accordance with the benefit limitation rules of section 436 for periods before the date of enactment.

A plan is an eligible charity plan for a plan year if it is maintained by more than one employer, 100 percent of whom are tax exempt organizations under section 501(c)(3).[335] For purposes of the provision, the determination of whether a plan is maintained by more than one employer is determined without regard to the controlled group rules of section 414(c).

Effective Date

In general, the provision is effective as if included in PPA. The provisions relating to eligible charity plans are effective for plan years beginning after December 31, 2007, except that a plan sponsor may elect to apply the provision to plan years beginning after December 31, 2008, pursuant to elections made at the time and in the manner prescribed by the Secretary. An election may be revoked only with the consent of the Secretary.

3. Lookback for certain benefit restrictions (sec. 303 of the bill and sec. 436 of the Code)

Present Law

Benefit restrictions

A single-employer defined benefit pension plan is required to comply with certain funding-based limits described in section 436 on benefits and benefit accruals if a plan's adjusted funding target attainment percentage is below a certain level.[336] These limits were added by the PPA and are generally applicable to plan years beginning after December 31, 2007. The term "funding target attainment percentage" is defined in the same way as under the minimum funding rules applicable to single-employer defined benefit pension plans, and is the ratio, expressed as a percentage, that the value of the plan's assets (generally reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to a whether a plan is in at-risk status under the minimum funding rules). A plan's adjusted funding target attainment percentage is determined in the same way, except that the value of the plan's assets and the plan's funding target are both increased by the aggregate amount of purchases of annuities for employees other than highly compensated employees made by the plan during the two preceding plan years. Special rules apply for determining a plan's adjusted funding target attainment percentage in the case of a fully funded plan and for plan years beginning in 2007 and before 2011.

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[335] Generally, an organization is exempt under section 501(c)(3) if it is a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in, any political campaign of any candidate for public office.

[336] Secs. 401(a)(29) and 436. Parallel rules apply under ERISA.

Prohibited payments

General rule

A plan must provide that, if the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan will not make any "prohibited payments" after the valuation date for the plan year.[337] For purposes of these limitations, a prohibited payment is (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period, (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract), (3) any transfer of assets and liabilities to another plan maintained by the same employer (or by any member of the employer's controlled group) that is made in order to avoid or terminate the application of the PPA benefit limitations; or (4) any other payment specified by the Secretary by regulations.

A plan must also provide that, if the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater, but less than 80 percent, the plan may not pay any prohibited payments exceeding the lesser of: (1) 50 percent of the amount otherwise payable under the plan; and (2) the present value of the maximum PBGC guarantee with respect to the participant (determined under guidance prescribed by the PBGC, using the interest rates and mortality table applicable in determining minimum lump-sum benefits). The plan must provide that only one payment under this exception may be made with respect to any participant[338] during any period of consecutive plan years to which the limitation applies.

In addition, a plan must provide that, during any period in which the plan sponsor is in bankruptcy proceedings, the plan may not make any prohibited payment. This limitation does not apply on or after the date the plan's enrolled actuary certifies that the adjusted funding target attainment percentage of the plan is not less than 100 percent.

With respect to the prohibited payment rule, certain frozen plans, meaning plans that do not provide for any future benefit accruals, are grandfathered. The prohibited payment limitation does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on September 1, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period. In addition, in the case of a terminated plan, while any benefit restriction in effect immediately before the termination of the plan continues to apply, the limitation on prohibited payments does not apply to payments made to carry out the termination of the plan in accordance with applicable law.[339]

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[337] Sec. 436(d).

[338] For purposes of the prohibited payment rules, the benefits provided with respect to a participant and any beneficiary of the participant (including an alternate payee) are aggregated. If the participant's accrued benefit is allocated to an alternate payee and one or more other persons, the amount that may be distributed is allocated in the same manner unless the applicable qualified domestic relations order provides otherwise.

[339] Treas. Reg. sec. 1.436-1(a)(3)(ii).

Definition of social security supplement

A social security supplement is an ancillary benefit that is permitted to be offered under a defined benefit plan. An ancillary benefit is benefit provided under the plan that is not a retirement-type subsidy or an optional form of payment of a participant's accrued benefit. It is benefit that is paid in addition to a participant's accrued benefit or any benefit treated as an accrued benefit. Specifically a social security supplement is a benefit for plan participants that commences before the age and terminates before the age when participants are entitled to old-age insurance benefits, unreduced on account of age, under title II of the Social Security Act, as amended (see section 202(a) and (g) of such Act), and does not exceed such old-age insurance benefit.[340]

Treatment of payments under social security leveling feature

A social security leveling feature is a feature with respect to an optional form of payment of a participant's accrued benefit commencing prior to a participant's expected commencement of social security benefits that provides for a temporary period of higher payments which is designed to result in an approximately level amount of income when the participant's estimated old age benefits from Social Security are taken into account.[341] Even though an optional form of benefit with this feature may provide the same stream of payments as a single life annuity plus a social security supplement, the amount in excess of a single life annuity paid before social security retirement age is a prohibited payment.

Limitation on future benefit accruals

Among the benefit limitations is a requirement that if the plan's adjusted funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year ("future benefit accrual limitation"). This future benefit accrual limitation applies only for purposes of the accrual of benefits; service during the freeze period is counted for other purposes. For example, if accruals are frozen pursuant to the limitation, service performed during the freeze period still counts for vesting purposes. Written notice must be provided to plan participants and beneficiaries if a future benefit accrual limitation or any other section 436 limitation provision applies to a plan.

A future benefit accrual limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent. The future benefit accrual limitation also does not apply for the first five years a plan (or a predecessor plan) is in effect.

If a future benefit accrual limitation ceases to apply to a plan, all such benefit accruals resume, effective as of the day following the close of the period for which the limitation applies.

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[340] Treas. Reg. sec. 1.411(a)-7(c)(4)

[341] Treas. Reg. 1.411(d)-3(g)(16)

In addition, section 436 provides that nothing in the rules is to be construed as affecting a plan's treatment of benefits which would have been paid or accrued but for the limitation.

Temporary modification of application of limitation on benefit accruals under WRERA

Under section 203 of WRERA, in the case of the first plan year beginning during the period of October 1, 2008, through September 30, 2009 ("WRERA relief plan year"), the future benefit accrual limitation rules under section 436 are applied by substituting the plan's adjusted funding target attainment percentage for the preceding plan year for the adjusted funding target attainment percentage for the WRERA relief plan year. Thus, the future benefit accrual limitation of section 436 is avoided if the plan's adjusted funding target attainment percentage for the preceding plan year is 60 percent or greater. This substitution of the plan's adjusted funding target attainment percentage is not intended to place a plan in a worse position with respect to the future benefit accrual limitation of section 436 than would apply absent the WRERA relief. Thus, the substitution does not apply if the adjusted funding target attainment percentage for the WRERA relief plan year is greater than the preceding year.

Explanation of Provision

Limitation on future benefit accruals

The provision extends the temporary modification of the limitation on benefit accruals under section 203 of WRERA to the plan year beginning during the period of October 1, 2009 through September 30, 2010 and provides a special rule for any plan for which the valuation date is not the first day of the plan year. Under the provision, in the case of any plan year beginning during the period of October 1, 2008, through September 30, 2010, the future benefit accrual limitation rules under section 436 are applied by substituting the plan's adjusted funding target attainment percentage for any such plan year with the plan's adjusted funding target attainment percentage for the plan year beginning after October 1, 2007, and before October 1, 2008, as determined under rules prescribed by the Secretary. In the case of a plan for which the valuation date is not the first day of the plan year, for any plan years beginning after December 31, 2007, and before January 1, 2010, the future benefit accrual limitation rules under section 436 are applied by substituting the plan's adjusted funding target attainment percentage for any such plan year with the plan's adjusted funding target attainment percentage for the last plan year beginning before November 1, 2007, as determined under rules prescribed by the Secretary.

This substitution only applies if it results in a greater adjusted funding target attainment percentage for a plan for the relevant plan year. Thus, the future benefit accrual limitation of section 436 is avoided if the plan's adjusted funding target attainment percentage for the plan year beginning after October 1, 2007, and before October 1, 2008, is 60 percent or greater (or, in the case of a plan for which the valuation date is not the first day of the plan year, if the adjusted funding target attainment percentage for the plan year beginning before November 1, 2007 is 60 percent or greater). Because the provision applies to the same period as section 203 of WRERA, it explicitly provides that section 203 of WRERA applies to a plan for any plan year in lieu of the provision only to the extent that such section produces a higher adjusted funding target attainment percentage for such plan for such year.

Prohibited payments

Under the provision, in the case of any plan year beginning during the period of October 1, 2008, through September 30, 2010 (or, in the case of plan where the plan's valuation date is not the first day of the plan year, for any plan years beginning after December 31, 2007, and before January 1, 2010), the same substitution of the plan's adjusted funding target attainment percentage as applies for purposes of the limitation on benefit accruals also applies for purposes of determining whether a plan can pay a prohibited payment in the form of a social security leveling option. For this purpose, a social security leveling option is a payment option which accelerates payments under the plan before, and reduces payments after, a participant starts receiving social security payments in order to provide substantially similar payments before and after such benefits are received.

Effective Date

The provision generally is effective for plan years beginning on or after October 1, 2008. In the case of a plan for which the valuation date is not the first day of the plan year, the provision applies to plan years beginning after December 31, 2007.

4. Lookback for credit balance rule for plans maintained by charities (sec. 304 of the bill and sec. 430 of the Code)

Present Law

In general

Under the PPA funding rules, credit balances that accumulated under pre-PPA law ("funding standard carryover balances") are preserved and, for plan years beginning after 2007, new credit balances (referred to as "prefunding balances") result if a plan sponsor makes contributions greater than those required under the PPA funding rules. In general, plan sponsors may choose whether to count funding standard carryover balances and prefunding balances in determining the value of plan assets or to use the balances to reduce required contributions, but not both.

Funding standard carryover balance

The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2007 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For each plan year beginning after 2008, the funding standard carryover balance is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

Prefunding balance

The prefunding balance consists of a beginning balance of zero for the 2008 plan year, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years, i.e., as of the first day of plan year beginning after 2008 (the "current" plan year), the plan sponsor may increase the prefunding balance by an amount, not to exceed: (1) the excess (if any) of the aggregate total employer contributions for the preceding plan year, over (2) the minimum required contribution for the preceding plan year. For this purpose, any excess contribution for the preceding plan year is adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined using the effective interest rate of the plan for the preceding plan year and treating contributions as being first used to satisfy the minimum required contribution.

In determining the amount of the increase in a plan's prefunding balance, the amount by which the aggregate total employer contributions for the preceding plan year exceeds the minimum required contribution for the preceding plan year is reduced (but not below zero) by the amount of contributions an employer would need to make to avoid a benefit limitation that would otherwise be imposed for the preceding plan year under the rules relating to benefit limitations for single-employer plans (as discussed below).[342]

For each plan year beginning after 2008, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the prefunding balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

Application of balances to the value of plan assets or to reduce minimum required contributions

If a plan sponsor elects to maintain a funding standard carryover balance or prefunding balance, the amount of those balances is generally subtracted from the value of plan assets for purposes of determining a plan's minimum required contributions, including a plan's funding shortfall, and a plan's funding target attainment percentage (defined as the ratio, expressed as a percentage, that the value of the plan's assets bears to the plan's funding target for the year). The value of a plan's assets is not reduced by these balances if a binding written agreement with the PBGC providing that all or a portion of the plan's funding standard carryover balance or prefunding balance is not available to offset the minimum required contribution for a plan year is in effect. In addition, for purposes of determining whether a plan is required to establish a shortfall amortization base for a plan year, the funding standard carryover balance is not

[342] Any contribution that may be taken into account in satisfying the requirement to make additional contributions with respect to more than one type of benefit limitation is taken into account only once for purposes of this reduction.

subtracted from the value of plan assets and the prefunding balance is required to be subtracted from the value of plan assets only if an election has been made to use the balance to offset the plan's minimum required contribution for the plan year. However, the plan sponsor may elect to permanently reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year.

If the value of the plan's assets (reduced by any prefunding balance but not by any funding standard carryover balance) is at least 80 percent of the plan's funding target for the preceding plan year, a plan sponsor is generally permitted to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year, thus reducing the amount that must be contributed for the current plan year.[343] If a plan sponsor has elected to permanently reduce a funding standard carryover balance or prefunding balance, any reduction of such balances applies before determining the amount that is available for crediting against minimum required contributions for the plan year.

<u>Other rules</u>

In determining the prefunding balance or funding standard carryover balance as of the first day of a plan year, the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary to reflect the rate of return on plan assets for the preceding year.[344] The rate of return is determined on the basis of the fair market value of the plan assets and must properly take into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

To the extent that a plan has a funding standard carryover balance of more than zero for a plan year, none of the plan's prefunding balance may be credited to reduce a minimum required contribution, nor may an election be made to reduce the prefunding balance for purposes of determining the value of plan assets. Thus, the funding standard carryover balance must be used for these purposes before the prefunding balance may be used.

Any election relating to the prefunding balance and funding standard carryover balance is to be made in such form and manner as the Secretary prescribes.[345]

Explanation of Provision

Under the provision, for any plan year beginning on or after August 31, 2009, and before September 1, 2011, for purposes of determining whether the plan is sufficiently funded so as to be permitted to credit all or a portion of its funding standard carryover balance or prefunding

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[343] In the case of plan years beginning in 2008, the percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

[344] Treas. Reg. sec. 1.430(f)-1(b)(3).

[345] See Treas. Reg. sec. 1.430(f)-1(f) for the rules governing elections relating to prefunding balances and funding standard carryover balances.

balance against the minimum required contribution for the plan year, the plan may use the greater of: (1) its funding target attainment percentage (determined without regard to the provision) for the prior plan year, or (2) the funding target attainment percentage for the plan year beginning after August 31, 2007 and before September 1, 2008, as determined under rules prescribed by the Secretary. Thus, the provision temporarily permits plans whose funded status for the lookback year was at least equal to 80 percent to offset their minimum required contributions by a credit balance, even if the plan would not otherwise be permitted to do so.

For plans with valuation dates other than the first day of the plan year, the provision applies for any plan year beginning after December 31, 2007, and before January 1, 1010, and the plan may use the funding target attainment percentage for the last plan year beginning before September 1, 2007, as determined under rules prescribed by the Secretary.

The provision applies only to plans maintained exclusively by one or more charitable organizations exempt from tax under section 501(c)(3).

Effective Date

The provision is generally effective for plan years beginning after August 31, 2009. For plans with valuation dates other than the first day of the plan year, the provision is effective for plan years beginning after December 31, 2008.

B. Multiemployer Plans

1. Adjustments to funding standard account rules (sec. 311 of the bill and sec. 431 of the Code)

Present Law

Defined benefit pension plans generally are subject to minimum funding rules under the Code that require the sponsoring employer to periodically make contributions to fund plan benefits. Similar rules apply to defined benefit pension plans under the Labor Code provisions ERISA.

The minimum funding rules for single-employer and multiemployer plans are different.[346] A single-employer plan is a plan that is not a multiemployer plan. A multiemployer plan is generally a plan to which more than one employer is required to contribute and which is maintained pursuant to a collective bargaining agreement.[347]

Funding standard account

A multiemployer defined benefit pension plan is required to maintain a special account called a "funding standard account" to which charges and credits (such as credits for plan contributions) are made for each plan year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, the plan has an "accumulated funding deficiency" equal to the amount of such excess charges. For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount is required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceeds charges, a "credit balance" results. The amount of the credit balance, increased with interest, can be used to reduce future required contributions.

Amortization periods

A plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an acceptable actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as the: (1) normal cost and (2) amortization of supplemental cost. The normal cost for a plan for a plan year generally represents the cost of future benefits allocated to the plan year under the funding method used by the plan for current employees. The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets, such as a net experience loss. Supplemental costs are amortized (i.e., recognized for

[346] The PPA modified the minimum funding rules for multiemployer defined benefit pension plans. These modifications are generally effective for plan years beginning after 2007

[347] Sec. 414(f).

funding purposes) over a specified number of years, depending on the source. The amortization period applicable to a multiemployer plan for most credits and charges is 15 years.[348] Past service liability under the plan is amortized over 15 years[349]; past service liability due to plan amendments is amortized over 15 years; and experience gains and losses resulting from a change in actuarial assumptions are amortized over 15 years. Experience gains and losses and waived funding deficiencies are also amortized over 15 years.

The Secretary, upon receipt of an application, is required to grant an extension of the amortization period for up to five years with respect to any unfunded past service liability, investment loss, or experience loss.[350] There must be included with the application a certification by the plan's actuary that: (1) absent the extension, the plan would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years; (2) the plan sponsor has adopted a plan to improve the plan's funding status; (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures; and (4) required notice has been provided. The automatic extension provision does not apply with respect to any application submitted after December 31, 2014. The Secretary may also grant an additional extension of such amortization periods for an additional five years, using the same standards for determining whether such an extension may be granted as under the pre-PPA minimum funding rules.[351]

Actuarial assumptions

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which must reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

Valuation of plan assets

In determining the charges and credits to be made to the plan's funding standard account for a multiemployer plan, the value of plan assets may be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is

[348] Sec. 431(b)(2). Prior to the effective date of PPA, the amortization period was 30 years for past service liability, past service liability due to plan amendments, and losses and gains resulting from a change in actuarial assumptions.

[349] In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA was amortized over 30 years. Past service liability due to plan amendments was amortized over 30 years.

[350] Sec. 431(d)(1).

[351] Sec. 431(d)(2).

permitted under regulations prescribed by the Secretary.[352] Thus, the actuarial value of a plan's assets under a reasonable actuarial valuation method can be used instead of fair market value. A reasonable actuarial valuation method generally can include a smoothing methodology that takes into account reasonable expected investment returns and average values of the plan assets, so long as the smoothing or averaging period does not exceed the five most recent plan years, including the current plan year. In addition, in order to be reasonable, any actuarial valuation method used by the plan is required to result in a value of plan assets that is not less than 80 percent of the current fair market value of the assets and not more than 120 percent of the current fair market value.[353] In determining plan funding under an acceptable actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan.

The actuarial valuation method is considered to be part of the plans funding method. The same method must be used each plan year. If the valuation method is changed, the change is only permitted to take effect if approved by the Secretary of Treasury.[354]

Additional funding rules for plans in endangered or critical status

Under section 432,[355] additional funding rules apply to a multiemployer defined benefit pension plan that is in endangered or critical status. These rules require the adoption of and compliance with: (1) a funding improvement plan in the case of a multiemployer plan in endangered status; and (2) a rehabilitation plan in the case of a multiemployer plan in critical status. In the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Section 432 is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014, except that a plan operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015 must continue to operate under such plan until the funding improvement or rehabilitation period (as explained below) expires or the plan emerges from endangered or critical status.

[352] Sec. 431(c)(2).

[353] Treas. Reg. sec. 1.412(c)(2)-1(b). Rev. Proc. 2000-40, 2000-2 CB 357, generally indicates that only an averaging period that does not exceed five years will be approved by the IRS. The revenue procedure also indicates that for a funding valuation method to be approved, the asset value determined under the method must be adjusted to be no greater than 120 percent and no less than 80 percent of the fair market value.

[354] Sec. 412(d)(1).

[355] Parallel rules apply under ERISA.

Failure to comply with minimum funding rules

In the event of a failure to comply with the minimum funding rules, the Code imposes a two-level excise tax on the plan sponsor.[356] The initial tax is five percent of the plan's accumulated funding deficiency for multiemployer plans. An additional tax is imposed if the failure is not corrected before the date that a notice of deficiency with respect to the initial tax is mailed to the employer by the IRS or the date of assessment of the initial tax. The additional tax is equal to 100 percent of the unpaid contribution or the accumulated funding deficiency, whichever is applicable. Before issuing a notice of deficiency with respect to the excise tax, the Secretary must notify the Secretary of Labor and provide the Secretary of Labor with a reasonable opportunity to require the employer responsible for contributing to, or under, the plan to correct the deficiency or comment on the imposition of the tax.

Explanation of Provision

Special funding relief rules

A plan sponsor of a multiemployer plan that meets a solvency test is permitted to use either one or both of two special funding relief rules for either or both of two plan years.

Amortization of net investment losses

The first special funding relief rule allows the plan sponsor to treat the portion of its experience loss attributable to the net investment losses (if any) incurred in either or both of the first two plan years ending after August 31, 2008, as an item separate from other experience losses, to be amortized in equal annual installments (until fully amortized) over the period beginning with the plan year in which such portion is first recognized in the actuarial value of assets and ending in the 30-plan-year period beginning with the plan year in which the net investment loss was incurred. If this treatment is used for a plan year, the plan sponsor will not be eligible for an extension of this amortization period for this separate item, and if an extension was granted before electing this treatment of net investment losses, such extension must not result in such amortization period exceeding 30 years.

A plan sponsor is required to determine its net investment losses in the manner described by the Secretary, on the basis of the difference between actual and expected returns (including any difference attributable to any criminally fraudulent investment). The determination as to whether an arrangement is a criminally fraudulent investment arrangement shall be made under rules substantially similar to the rules prescribed by the Secretary for purposes of section 165.

Expanded smoothing period and asset valuation corridor

Under the other special funding relief rule, a multiemployer plan may change its asset valuation method in a manner which spreads the difference between the expected returns and

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[356] Sec. 4971. Special rules apply under section 4971 for multiemployer plans in endangered or critical status.

actual returns for either or both of the first two plan years ending before August 31, 2008 over a period of not more than 10 years. However, as under present law, spreading the difference between expected and actual returns under a plan's asset valuation method is only permitted if it does not result in a value of plan assets, when compared to the current fair market value of the plan assets, to be at any time outside an asset valuation corridor.

Under this special funding relief rule, the asset valuation corridor is expanded so that, for either or both of the first two plan years ending before August 31, 2008, the plan's asset value must be adjusted under the valuation method being used so the value of plan assets is not less than 80 percent of the current fair market value of the assets and not more than 130 percent of the current fair market value (rather than 120 percent). This expanded valuation corridor is available whether or not the plan sponsor increases the period for spreading the difference between expected and actual returns under its asset valuation method.

If a plan sponsor uses either or both of the options (extending the spreading period and the expanded asset valuation corridor) under this special relief rule for one or both of these plan years, the Secretary will not treat the asset valuation method of the plan as unreasonable because of such change and the change will be deemed to be approved by the Secretary.

Amortization of reduction in unfunded accrued liability

To the extent a plan sponsor uses both of the two special funding relief rules for any plan year, the plan is required to treat any resulting reduction in the plan's unfunded accrued liability as a separate experience amortization base. This separate experience amortization base is amortized in annual installments (until fully amortized) over a period of 30 plan years (rather than the otherwise applicable amortization period).

Solvency test

The solvency test is satisfied only if the plan actuary certifies that the plan is projected to have sufficient assets to timely pay expected benefits and anticipated expenditures over the amortization period taking into account the changes in the funding standard account under the special funding relief rule elected.

Benefit restriction

If a plan sponsor of a multiemployer plan uses one, or both, of the special funding relief rules under this provision, then, in addition to any other applicable restrictions on benefit increases, the following limit also applies. A plan amendment increasing benefits may not go into effect during either of the two plan years immediately following any plan year to which such election first applies unless one of the following conditions is satisfied. Either (1) the plan actuary certifies that such increase is paid for out of additional contributions not allocated to the plan at the time the election was made, and the plan's funded percentage and projected credit balances for such two plan years are reasonably expected to be generally at the same levels as such percentage and balances would have been if the benefit increase had not been adopted, or (2) the amendment is required to maintain the plan's status as a qualified retirement plan under the applicable provisions of the Code or to comply with other applicable law.

Reporting

A plan sponsor of a multiemployer plan that uses one or both of these special funding relief rules must give notice to participants and beneficiary of its use of the relief and must inform the PBGC of its use of the relief in such form and manner, as the Director of the PBGC may prescribe.

Effective Date

The provision takes effect as of the first day of the first plan year ending after August 31, 2008. However, if a plan sponsor uses either (or both) of the special funding relief provisions and such use affects on the plan's funding standard account for the first plan year ending before August 31, 2008, the use of the rule is disregarded for purposes of applying the provisions for additional funding for multiemployer plans in endangered or critical status under section 432 to such plan year. The restriction on plan amendments increasing benefits is effective on the date of enactment of this provision.

TITLE IV − OFFSET PROVISIONS

A. Exclusion of Unprocessed Fuel from the Cellulosic Biofuel Producer Credit (sec. 401 of the bill and sec. 40 of the Code)

Present Law

The "cellulosic biofuel producer credit" is a nonrefundable income tax credit for each gallon of qualified cellulosic fuel production of the producer for the taxable year. The amount of the credit is generally \$1.01 per gallon.[357]

"Qualified cellulosic biofuel production" is any cellulosic biofuel which is produced by the taxpayer and which is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified cellulosic biofuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such cellusic biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).

"Cellulosic biofuel" means any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act. The cellulosic biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of cellulosic biofuel.

Cellulosic biofuel eligible for the section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.[358]

Because it is a credit under section 40(a), the cellulosic biofuel producer credit is part of the general business credits in section 38. However, the credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the alternative minimum tax. Under section 87, the credit is included in gross income. The cellulosic biofuel producer credit terminates on December 31, 2012.

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not

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[357] In the case of cellulosic biofuel that is alcohol, the \$1.01 credit amount is reduced by the credit amount of the alcohol mixture credit, and for ethanol, the credit amount for small ethanol producers, as in effect at the time the cellulosic biofuel fuel is produced.

[358] See secs. 40A(d)(1), 40A(f)(3), and 6426(h).

consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

In an informal Chief Counsel Advice ("CCA"), the IRS has concluded that black liquor is a liquid fuel from biomass and may qualify for the cellulosic biofuel producer credit, as well as the refundable alternative fuel mixture credit.[359] A taxpayer cannot claim both the alternative fuel mixture credit and the cellulosic biofuel producer credit. The alternative fuel credits and payment provisions expired December 31, 2009.

Explanation of Provision

The provision modifies the cellulosic biofuel producer credit to exclude fuels with significant water, sediment, or ash content, such as black liquor. Consequently, credits will cease to be available for these fuels. Specifically, the provision excludes from the definition of cellulosic biofuel any fuels that (1) are more than four percent (determined by weight) water and sediment in any combination, or (2) have an ash content of more than one percent (determined by weight). Water content (including both free water and water in solution with dissolved solids) is determined by distillation, using for example ASTM method D95 or a similar method suitable to the specific fuel being tested. Sediment consists of solid particles that are dispersed in the liquid fuel and is determined by centrifuge or extraction using, for example, ASTM method D1796 or D473 or similar method that reports sediment content in weight percent. Ash is the residue remaining after combustion of the sample using a specified method, such as ASTM D3174 or a similar method suitable for the fuel being tested.

Effective Date

The provision is effective for fuel sold or used after date of enactment.

[359] IRS CCA 200941011, 2009 WL 3239569 (June 30, 2009). The Code provides for a tax credit of 50 cents for each gallon of alternative fuel used to produce an alternative fuel mixture that is used or sold for use as a fuel. (sec. 6426(e)). Under Notice 2006-92, an alternative fuel mixture is a mixture of alternative fuel and a taxable fuel (such as diesel) that contains at least 0.1 percent taxable fuel. Liquid fuel derived from biomass is an alternative fuel (sec. 6426(d)(2)(G)). Diesel fuel has been added to black liquor to qualify for the alternative mixture credit and the mixture is burned in a recovery boiler as fuel. Persons that have an alternative fuel mixture credit amount in excess of their taxable fuel excise tax liability may make a claim for payment from the Treasury in the amount of the excess.

B. Prohibition on Alternative Fuel and Alternative Fuel Mixture Credit for Black Liquor (sec. 402 of the bill and secs. 6426 and 6427 of the Code)

Present Law

The Code provides two excise tax credits with respect to alternative fuel that are calculated on a per-gallon basis, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process ("coal-to-liquids"), compressed or liquified gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after September 30, 2009, through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 50 percent of such facility's total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against the excise tax imposed under section 4041, and the alternative fuel mixture credit is allowed against the excise tax imposed under section 4081. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents[360] of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation, or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An "alternative fuel mixture" is a mixture of alternative fuel and taxable fuel that contains at least 1/10 of one percent taxable fuel.[361] The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits do not apply after December 31, 2009.

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally do not apply after December 31, 2009. With respect to liquefied hydrogen, the credit and payment provisions expire after September 30, 2014. The alternative fuel credit and alternative fuel mixture credit must first be applied to excise tax liability for special and alternative fuels, and any excess credit may be taken as a payment.

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[360] "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

[361] See Internal Revenue Service, Notice 2006-92, *Alternative Fuel, Alternative Fuel Mixtures; Blood Collector Organizations*, 2006-43 I.R.B. 774 (October 23, 2006).

The kraft process for making paper produces a byproduct called black liquor, which has been used for decades by paper manufacturers as a fuel in the papermaking process. Black liquor is composed of water, lignin and the spent chemicals used to break down the wood. The amount of the biomass in black liquor varies. The portion of the black liquor that is not consumed as a fuel source for the paper mills is recycled back into the papermaking process. Black liquor has ash content (mineral and other inorganic matter) significantly above that of other fuels.

In an informal Chief Counsel Advice ("CCA"), the IRS has concluded that black liquor is a liquid fuel from biomass and may qualify for the cellulosic biofuel producer credit, as well as the refundable alternative fuel mixture credit.[362] A taxpayer cannot claim both the alternative fuel mixture credit and the cellulosic biofuel producer credit.

Explanation of Provision

For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, the provision excludes fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp. Consequently, credits will cease to be available for these fuels.

Effective Date

The provision is effective for fuel sold or used after December 31, 2009.

[362] IRS CCA 200941011, 2009 WL 3239569 (June 30, 2009). The Code provides for a tax credit of 50 cents for each gallon of alternative fuel used to produce an alternative fuel mixture that is used or sold for use as a fuel. (sec. 6426(e)). Under Notice 2006-92, an alternative fuel mixture is a mixture of alternative fuel and a taxable fuel (such as diesel) that contains at least 0.1 percent taxable fuel. Liquid fuel derived from biomass is an alternative fuel (sec. 6426(d)(2)(G)). Diesel fuel has been added to black liquor to qualify for the alternative mixture credit and the mixture is burned in a recovery boiler as fuel. Persons that have an alternative fuel mixture credit amount in excess of their taxable fuel excise tax liability may make a claim for payment from the Treasury in the amount of the excess.

C. Modifications to Homebuyer Credit (sec. 411 of the bill and sec. 36 of the Code)

Present Law

In general

An individual who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of $8,000 ($4,000 for a married individual filing separately) or 10 percent of the purchase price of a principal residence. An individual is considered a first-time homebuyer if the individual had no ownership interest in a principal residence in the United States during the 3-year period prior to the purchase of the home. A long-time resident of the same principal residence—an individual (and, if married, the individual's spouse) who has maintained the same principal residence for any five-consecutive year period during the eight-year period ending on the date of the purchase of a subsequent principal residence— is treated as a first-time homebuyer. The maximum allowable credit for such taxpayers is $6,500 ($3,250 for a married individual filing separately).

The credit is allowed for qualifying home purchases on or after April 9, 2008, and before May 1, 2010.[363] The credit applies to the purchase of a principal residence before July 1, 2010 by any taxpayer who enters into a written binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010. In the case of any individual (and, if married, the individual's spouse) who serves on qualified official extended duty service outside of the United States for at least 90 days during the period beginning after December 31, 2008, and ending before May 1, 2010, the expiration date of the first-time homebuyer credit is extended for one year, through May 1, 2011 (July 1, 2011, in the case of an individual who enters into a written binding contract before May 1, 2011, to close on the purchase of a principal residence before July 1, 2011).

A taxpayer may elect to treat the purchase of a home as made on December 31 of the calendar year preceding the purchase for purposes of claiming the credit on the prior year's tax return.

No District of Columbia first-time homebuyer credit[364] is allowed to any taxpayer with respect to the purchase of a residence after December 31, 2008, if the national first-time homebuyer credit is allowable to such taxpayer (or the taxpayer's spouse) with respect to such purchase.

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[363] For purchases before January 1, 2009, the dollar limits are $7,500 ($3,750 for a married individual filing separately).

[364] Sec. 1400C.

Limitations

The credit phases out for individual taxpayers with modified adjusted gross income between \$125,000 and \$145,000 (\$225,000 and \$245,000 for joint filers) for the year of purchase.

No credit is allowed for the purchase of any residence if the purchase price exceeds \$800,000.

No credit is allowed unless the taxpayer is 18 years of age as of the date of purchase. A taxpayer who is married is treated as meeting the age requirement if the taxpayer or the taxpayer's spouse meets the age requirement.

The definition of purchase excludes property acquired from a person related to the person acquiring such property or the spouse of the person acquiring the property, if married.

No credit is allowed to any taxpayer if the taxpayer is a dependent of another taxpayer.

No credit is allowed unless the taxpayer attaches to the relevant tax return a properly executed copy of the settlement statement used to complete the purchase. This limitation applies to returns for taxable years ending after November 6, 2009.

Recapture

For homes purchased on or before December 31, 2008, the credit is recaptured ratably over fifteen years with no interest charge beginning in the second taxable year after the taxable year in which the home is purchased. For example, if an individual purchases a home in 2008, recapture commences with the 2010 tax return. If the individual sells the home (or the home ceases to be used as the principal residence of the individual or the individual's spouse) prior to complete recapture of the credit, the amount of any credit not previously recaptured is due on the tax return for the year in which the home is sold (or ceases to be used as the principal residence).[365] However, in the case of a sale to an unrelated person, the amount recaptured may not exceed the amount of gain from the sale of the residence. For this purpose, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured.

No amount is recaptured after the death of an individual. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two-year period. In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture. Recapture does not apply to a home purchased after December 31, 2008 that is treated (at the election of the taxpayer) as purchased on December 31, 2008.

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[365] If the individual sells the home (or the home ceases to be used as the principal residence of the individual and the individual's spouse) in the same taxable year the home is purchased, no credit is allowed.

For homes purchased after December 31, 2008, the credit is recaptured only if the taxpayer disposes of the home (or the home otherwise ceases to be the principal residence of the taxpayer) within 36 months from the date of purchase.

In the case of a disposition of principal residence by an individual (or a cessation of use of the residence that otherwise would cause recapture) after December 31, 2008, in connection with Government orders received by the individual (or the individual's spouse) for qualified official extended duty service, no recapture applies by reason of the disposition of the residence,[366] and any 15-year recapture with respect to a home acquired before January 1, 2009, ceases to apply in the taxable year the disposition occurs.

Mathematical error authority

For purposes of administration of the credit by the Internal Revenue Service ("IRS"), the IRS may assess additional tax without issuance of a notice of deficiency as otherwise required[367] in the case of: an omission of any increase in tax required by the recapture provisions of the credit; information from the person issuing the taxpayer identification number of the taxpayer that indicates that the taxpayer does not meet the age requirement of the credit; information provided to the Secretary by the taxpayer on an income tax return for at least one of the two preceding taxable years that is inconsistent with eligibility for such credit; or, failure to attach to the return a properly executed copy of the settlement statement used to complete the purchase.

Explanation of Provision

Additional documentation requirements

In the case of a long-time resident of the same principal residence, no credit is allowable if the taxpayer fails to attach to the tax return for such taxable year a copy of such property tax bills or other documentation as are required by the Secretary to demonstrate compliance with the requirements of a long-time resident of the same principal residence.

In the case of a taxpayer to whom a credit would be allowed because the taxpayer enters into a written binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010, no credit is allowable if the taxpayer fails to attach to the tax return for such taxable year a copy of the binding contract.

Failure to comply with the additional documentation requirements described above is not within the scope of the definition of mathematical or clerical errors to which the exceptions to restrictions on assessment may apply in administering the credit.[368] Instead, if a credit is

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[366] If the individual sells the home (or the home ceases to be used as the principal residence of the individual and the individual's spouse) in connection with such orders in the same taxable year the home is purchased, the credit is allowable.

[367] Sec. 6213.

[368] Sec. 6213(g)(2).

disallowed on the grounds of the failure to comply with additional documentation requirements, normal administrative procedures apply and include examining the return or claim for refund and issuance of notices of deficiency or notices of disallowance of claims, as appropriate.

Modification of effective date for documentation requirement

The bill amends the effective date for the requirement to attach to the return a properly executed copy of the settlement sheet used to complete the purchase. This modified effective date is for returns filed after November 6, 2009, the date of enactment of the Worker, Homeownership, and Business Assistance Act of 2009.[369]

Effective Date

The additional documentation requirements apply to purchases on or after the date of enactment.

The modified effective date for the requirement to attach to the return a properly executed copy of the settlement sheet used to complete the purchase applies to purchases of a principal residence on or after November 6, 2009, the date of enactment of the Worker, Homeownership, and Business Assistance Act of 2009.

[369] Pub. L. No. 111-92.

D. Codification of Economic Substance Doctrine and Imposition of Penalties (sec. 421 of the bill and secs. 7701, 6662, 6662A, 6664 and 6676 of the Code)

Present Law

In general

The Code provides detailed rules specifying the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss, and deduction. These rules permit both taxpayers and the government to compute taxable income with reasonable accuracy and predictability. 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 a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants. Although these doctrines serve an important role in the administration of the tax system, they can be seen as at odds with an objective, "rule-based" system of taxation.

One common-law doctrine applied over the years 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.[370]

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[370] 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); *Klamath Strategic Investment Fund, LLC v. United States,* 472 F. Supp. 2d 885 (E.D. Texas 2007), *aff'd* 568 F.3d 537 (5th Cir. 2009); *Coltec Industries, Inc. v. United States,* 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied,* 127 S. Ct. 1261 (Mem.) (2007).

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" that lacked "commercial economic substance"). Certain "substance over form" cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed. See, e.g., *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd* 523 F.3d 461 (4th Cir. 2008). Although the Second Circuit found for the government in *TIFD III-E, Inc.*, on remand to consider issues under section 704(e), the District Court found for the taxpayer. See, *TIFD III-E Inc. v. United States*, No. 3:01-cv-01839, 2009 WL 3208650 (D. Conn. Oct. 23, 2009).

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of U.S. Federal income 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.[371]

Business purpose doctrine

A common law doctrine that often is considered together with the economic substance doctrine is the business purpose doctrine. The business purpose doctrine involves an inquiry into the subjective 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 activities with non-tax objectives have been combined with unrelated activities having only tax-avoidance objectives, in order to disallow the tax benefits of the overall transaction.[372]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[373] 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.[374] A narrower approach used by some courts is to conclude that either a business purpose or economic

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[371] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[372] See, *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[373] "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).

[374] 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."). See also, *Klamath Strategic Investment Fund v. United States*, 568 F. 3d 537, (5th Cir. 2009) (even if taxpayers may have had a profit motive, a transaction was disregarded where it did not in fact have any realistic possibility of profit and funding was never at risk).

substance is sufficient to respect the transaction.[375] 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.[376]

One decision by the Court of Federal Claims questioned the continuing viability of the doctrine. That court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers" though that court also found that the particular transaction at issue in the case did not lack economic substance. The Court of Appeals for the Federal Circuit ("Federal Circuit Court") overruled the Court of Federal Claims decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in question violated that doctrine.[377] The Federal Circuit Court stated that "[w]hile the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, [footnote omitted], a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."[378]

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[375] 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 outside 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.

[376] 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'.")

[377] *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *vacated and remanded,* 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied,* 127 S. Ct. 1261 (Mem.) (2007).

[378] The Federal Circuit Court stated that "when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." The Federal Circuit Court quoted a decision of its predecessor court, stating that "*Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance." The Court also stated that "while the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of a transaction in assessing its economic substance." *Coltec Industries, Inc. v. United States*, 454 F.3d at 1355, 1356.

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 demonstrate that a transaction has economic substance. Some courts have denied tax benefits on the grounds that a stated business benefit of a particular structure was not in fact obtained by that structure.[379] Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[380] 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.[381] 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.[382] In these cases, in assessing whether a reasonable possibility of profit exists, it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected tax benefits.

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least two courts have concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.[383] However, based on court decisions that

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[379] See, e.g., *Coltec Industries v. United States,* 454 F.3d 1340 (Fed. Cir. 2006). The court analyzed the transfer to a subsidiary of a note purporting to provide high stock basis in exchange for a purported assumption of liabilities, and held these transactions unnecessary to accomplish any business purpose of using a subsidiary to manage asbestos liabilities. The court also held that the purported business purpose of adding a barrier to veil-piercing claims by third parties was not accomplished by the transaction. 454 F.3d at 1358-1360 (Fed. Cir. 2006).

[380] 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).

[381] 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").

[382] See, e.g., *Rice's Toyota World v. Commissioner*, 752 F. 2d 89, 94 (4th Cir. 1985) (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 778, 781 (5th Cir. 2001) (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *57-58 (Fed. Cl. Jan. 8, 2010).

[383] See *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001), *aff'd*, 326 F.3d.737 (6th Cir. 2003) and *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *59 (Fed. Cl. Jan. 8, 2010).

recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.[384]

Tax-indifferent parties

A number of cases have involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax indifferent party from the transaction. Courts have sometimes concluded that this particular type of transaction did not satisfy the economic substance doctrine.[385] In other cases, courts have indicated that the substance of a transaction did not support the form of income allocations asserted by the taxpayer and have questioned whether asserted business purpose or other standards were met.[386]

Penalty regime

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 reported 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.[387] The section 6662 penalty is increased to 40 percent in the case of gross valuation misstatements as defined in section 6662(h). Except in the case of tax shelters,[388] the

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[384] 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 constitute a good business purpose.

[385] 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).

[386] See, e.g., *TIFD III-E, Inc. v. United States,* 459 F.3d 220 (2d Cir. 2006). Although the Second Circuit found for the government in *TIFD III-E, Inc*., on remand to consider issues under section 704(e), the District Court found for the taxpayer. See, *TIFD III-E Inc. v. United States*, No. 3:01-cv-01839, 2009 WL 3208650 (Oct. 23, 2009).

[387] Sec. 6662.

[388] 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).

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.[389] The relevant regulations for a tax shelter 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.[390] For transactions other than tax shelters, the relevant regulations provide a facts and circumstances test, the most important factor generally being the extent of the taxpayer's effort to assess the proper tax liability. If a taxpayer relies on an opinion, reliance is not reasonable if the taxpayer knows or should have known that the advisor lacked knowledge in the relevant aspects of Federal tax law, or if the taxpayer fails to disclose a fact that it knows or should have known is relevant. Certain additional requirements apply with respect to the advice.[391]

Listed transactions and reportable avoidance transactions

In general

A separate accuracy-related penalty under section 6662A applies to any "listed transaction" and to any other "reportable transaction" that is not a listed transaction, if a significant purpose of such transaction is the avoidance or evasion of Federal income tax[392] (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.

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[389] Sec. 6664(c).

[390] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

[391] See Treas. Reg. Sec. 1.6664-4(c). In addition to the requirements applicable to taxpayers under the regulations, advisors may be subject to potential penalties under section 6694 (applicable to return preparers), and to monetary penalties and other sanctions under Circular 230 (which provides rules governing persons practicing before the IRS). Under Circular 230, if a transaction is a "covered transaction" (a term that includes listed transactions and certain non-listed reportable transactions) a "more likely than not" confidence level is required for written tax advice that may be relied upon by a taxpayer for the purpose of avoiding penalties, and certain other standards must also be met. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.35. For other tax advice, Circular 230 generally requires a lower "realistic possibility" confidence level or a "non-frivolous" confidence level coupled with advising the client of any opportunity to avoid the accuracy related penalty under section 6662 by adequate disclosure. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.34.

[392] Sec. 6662A(b)(2).

Both listed transactions and other reportable transactions are allowed to be described by the Treasury department under section 6011 as transactions that must be reported, and section 6707A(c) 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.[393] 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.[394]

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.[395] 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 were 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. A "reasonable belief" must be based on the facts and law as they exist at the time that the return in question is filed, and not take into account the possibility that a return would not be audited. Moreover, reliance on professional advice may support a "reasonable belief" only in certain circumstances.[396]

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.[397] 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.[398] The IRS Commissioner is authorized to do this only if the

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[393] Sec. 6707A(c)(1).

[394] Sec. 6707A(c)(2).

[395] Sec. 6662A(a).

[396] Section 6664(d)(3)(B) does not allow a reasonable belief to be based on a "disqualified opinion" or on an opinion from a "disqualified tax advisor."

[397] Sec. 6662A(c).

[398] Sec. 6664(d).

failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[399]

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 specifies. 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).[400]

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);[401] 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.

Except as provided in regulations, a 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 when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.[402]

Strengthened reasonable cause exception

A penalty is not imposed under section 6662A 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;[403] (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such

[399] Sec. 6707A(d).

[400] Sec. 6707A(e).

[401] 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 (without regard to section 1211) be allowed for such year, will be treated as an increase in taxable income. Sec. 6662A(b).

[402] Sec. 6662A(e)(3).

[403] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

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.[404]

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[405] 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[406] 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 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.[407] Participation in the "management" of a transaction means involvement in the decision-making process regarding any

[404] Sec. 6664(d).

[405] 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).

[406] 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.

[407] 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). See Notice 2005-12, 2005-1 C.B. 494 regarding disqualified compensation arrangements.

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, finding 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

Any understatement upon which a penalty is imposed under section 6662A is not subject to the accuracy related penalty for underpayments under section 6662.[408] However, that understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement under section 6662(d)(1).[409] Thus, in the case of an understatement (as defined in sec. 6662(d)(2)), the amount of the understatement (determined without regard to section 6662A(e)(1)(A)) is increased by the aggregate amount of reportable transaction understatements for purposes of determining whether the understatement is a substantial understatement. The section 6662(a) penalty applies only to the excess of the amount of the substantial understatement (if any) after section 6662A(e)(1)(A) is applied over the aggregate amount of reportable transaction understatements.[410] Accordingly, every understatement is penalized, but only under one penalty provision.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty applies under section 6663 or to which the 40-percent penalty for gross valuation misstatements under section 6662(h) applies.[411]

Erroneous claim for refund or credit

If a claim for refund or credit with respect to income tax (other than a claim relating to the earned income tax credit) is made for an excessive amount, unless it is shown that the claim

[408] Sec. 6662(b) (flush language). In addition, section 6662(b) provides that section 6662 does not apply to any portion of an underpayment on which a fraud penalty is imposed under section 6663.

[409] Sec. 6662A(e)(1).

[410] Sec. 6662(d)(2)(A) (flush language)

[411] Sec. 6662A(e)(2).

for such excessive amount has a reasonable basis, the person making such claim is subject to a penalty in an amount equal to 20 percent of the excessive amount.[412]

The term "excessive amount" means the amount by which the amount of the claim for refund for any taxable year exceeds the amount of such claim allowable for the taxable year.

This penalty does not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under the accuracy related or fraud penalty provisions (including the general accuracy related penalty, or the penalty with respect to listed and reportable transactions, described above).

Explanation of Provision

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, in the case of any transaction[413] to which the economic substance doctrine is relevant, such transaction is treated as having 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 purpose (apart from Federal income tax effects) for entering into such transaction. The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus, the provision does not change present law standards in determining when to utilize an economic substance analysis.[414]

The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among[415] these basic transactions are (1) the choice between

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[412] Sec. 6676.

[413] The term "transaction" includes a series of transactions.

[414] If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available 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. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

[415] The examples are illustrative and not exclusive.

capitalizing a business enterprise with debt or equity;[416] (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;[417] (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;[418] and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[419] Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[420] As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.[421]

The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities

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[416] See, e.g., *John Kelley Co. v. Commissioner,* 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).

[417] See, e.g., *Sam Siegel v. Commissioner,* 45. T.C. 566 (1966), *acq.* 1966-2 C.B. 3. But see *Commissioner v. Bollinger,* 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under the facts and circumstances).

[418] See, e.g., *Rev. Proc. 2009-3 2009-1 I.R.B. 108, Secs. 3.01(38), (39), and (41)* (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); *compare Gregory v. Helvering*. 293 U.S. 465 (1935).

[419] See, e.g., *National Carbide v. Commissioner,* 336 U.S. 422 (1949), *Moline Properties v. Commissioner,* 319 U.S. 435 (1943); *compare, e.g. Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1; *Commissioner v. Bollinger,* 485 U.S. 340 (1988); see also sec. 7701(l).

[420] See, e.g., *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305, *aff'd*, 671 F. 2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982); *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied,* 127 S. Ct. 1261 (Mem) (2007); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd,* 523 F.3d 461 (4th Cir. 2008); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *60 (Fed. Cl. Jan. 8, 2010) (distinguishing leasing case *Consolidated Edison Company of New York*, No. 06-305T, 2009 WL 3418533 (Fed. Cl. Oct. 21, 2009) by observing that "considerations of economic substance are factually specific to the transaction involved").

[421] As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the Code, or does not have economic substance, see e.g., *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007) *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Tribune Company and Subsidiaries v. Commissioner*, 125 T.C. 110 (2005); *H.J. Heinz Company and Subsidiaries v. United States,* 76 Fed. Cl. 570 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007); *Long Term Capital Holdings LP v. United States,* 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd,* 150 Fed. Appx. 40 (2d Cir. 2005); *Klamath Strategic Investment Fund, LLC v. United States,* 472 F. Supp. 2d 885 (E.D. Texas 2007); *aff'd*, 568 F. 3d 537 (5th Cir. 2009); *Santa Monica Pictures LLC v. Commissioner,* 89 T.C.M. 1157 (2005).

with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.[422]

Conjunctive analysis

The provision clarifies that the economic substance doctrine involves a conjunctive analysis − there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such transaction, in order for a transaction to be treated as having economic substance. This clarification eliminates the disparity that exists among the Federal circuit courts 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.[423]

Non-Federal-tax business purpose

Under the provision, a taxpayer's non-Federal-income-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial."[424] For purposes of this analysis, any State or local income tax effect which is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. Also, a purpose of achieving a

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[422] See, e.g., *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007) ("the first asserted business purpose focuses on the wrong transaction--the creation of Garrison as a separate subsidiary to manage asbestos liabilities. . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale…") 454 F.3d 1340, 1358 (Fed. Cir. 2006). See also *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48; *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.").

[423] The provision defines "economic substance doctrine" as the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Thus, the definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both.

[424] 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:

> 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]

favorable accounting treatment for financial reporting purposes is not taken into account as a non-Federal-income-tax purpose if the origin of the financial accounting benefit is a reduction of Federal income tax.[425]

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 or that the taxpayer has a substantial non-Federal-income-tax purpose for entering into such transaction. The provision does not require or establish a minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, 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.[426] Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. In addition, the Secretary may choose to require treatment of foreign taxes as expenses in regulations.[427]

Personal transactions of individuals

In the case of an individual, the provision applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

Other rules

The Secretary is to prescribe such regulations 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, the provision does not alter or supplant any other rule of law,

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[425] 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. United States*, 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).

[426] 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 at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

[427] There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law. However, the Secretary may, in addition, choose to require treatment of foreign taxes as expenses as provided in regulations.

including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and the provision should be construed as being additive to any such other rule of law.

Penalty for understatements attributable to transactions lacking economic substance

The provision imposes a new strict liability penalty under section 6662 for an understatement attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new section 7701(o),[428] or failing to meet the requirements of any similar rule of law.[429] The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). Except as provided in regulations, an amended return or supplement to a return is not taken into account if filed after the taxpayer has been contacted for audit or such other date as is specified by the Secretary. No exceptions (including the reasonable cause rules) to the penalty are available. Thus, under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law. Similarly, a claim for refund or credit that is excessive under section 6676 due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is subject to the 20 percent penalty under that section, and the reasonable basis exception is not available.

The penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed.[430] The new 40-percent penalty for nondisclosed transactions is added to the penalties to which section 6662A will not also apply.[431]

As described above, under the provision, the reasonable cause and good faith exception of present law section 6664(c)(1) does not apply to any portion of an underpayment which is attributable to a transaction lacking economic substance, as defined in section 7701(o), or failing to meet the requirements of any similar rule of law. Likewise, the reasonable cause and good faith exception of present law section 6664(d)(1) does not apply to any portion of a reportable

[428] That provision generally provides that in any case in which 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 purpose (apart from Federal income tax effects) for entering into such transaction. Specific other rules also apply. See "Description of Proposal" for the immediately preceding provision, "Clarification of the economic substance doctrine."

[429] It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.

[430] As under present law, the penalties under section 6662 (including the new penalty) do not apply to any portion of an underpayment on which a fraud penalty is imposed.

[431] As revised by the provision, new section 6662A(e)(2)(b) provides that section 6662A will not apply to any portion of an understatement due to gross valuation misstatement under section 6662(h) or nondisclosed noneconomic substance transactions under new section 6662(i).

transaction understatement which is attributable to a transaction lacking economic substance, as defined in section 7701(o), or failing to meet the requirements of any similar rule of law.

Effective Date

The provision applies to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after the date of enactment.

AMENDMENTS

A. Extend for Two Years the GO Zone Low Income Housing Credit Rule (Amendment 3335 and sec. 1400N(c)(5) of the Code)

Present Law

In general

The low-income housing credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Credit cap

Generally, the aggregate credit authority provided annually to each State for a calendar year is specified dollar amount per resident with a minimum annual cap for certain small population States. These amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

Under a special provision, the otherwise applicable housing credit ceiling amount is increased for each of the States within the Gulf Opportunity Zone. This increase applies to calendar years 2006, 2007, and 2008. The additional credit cap for each of the affected States equals $18.00 times the number of such State's residents within the Gulf Opportunity Zone. This amount is not adjusted for inflation. This additional cap expires unless the applicable low-income buildings are placed in service before January 1, 2011.

Explanation of Provision

The provision extends the placed-in-service deadline (for two years) to January 1, 2013.

Effective Date

The provision is effective on the date of enactment.

B. Increase in Information Return Penalties (Amendment 3335 and sec. 6721 of the Code)

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721, any person who is required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year. If a failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is $100, with no calendar year limit.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Explanation of Provision

The provision increases the first-tier penalty from $15 to $30, and increases the calendar year maximum from $75,000 to $250,000. The second-tier penalty is increased from $30 to $60, and the calendar year maximum is increased from $150,000 to $500,000. The third-tier penalty is increased from $50 to $100, and the calendar year maximum is increased from $250,000 to $1,500,000. For small business filers, the calendar year maximum is increased from $25,000 to $75,000 for the first-tier penalty, from $50,000 to $200,000 for the second-tier penalty, and from $100,000 to $500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from $100 to $250. The provision also states that every five years the penalty amounts will be adjusted to account for inflation.

Effective Date

The provision applies with respect to information returns required to be filed on or after January 1, 2011.

C. Modifications to Mine Rescue Team Training Credit and Election to Expense Advanced Mine Safety Equipment (Amendment 3371 and secs. 38(c)(4) and 56(g)(4) of the Code)

Present Law

For a detailed discussion of present law relating to the mine rescue team training credit, please see the technical explanation of section 135 of the bill.

For a detailed discussion of present law relating to the election to expense advanced mine safety equipment, please see the technical explanation of section 144 of the bill.

Explanation of Provision

The provision permits the mine rescue team training credit, as extended under section 135 of the bill, to be allowable for purposes of computing the alternative minimum tax.

The provision allows for the expensing of mine safety equipment, as extended under section 144 of the bill, to be allowable for purposes of computing alternative minimum taxable income.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

D. Application of Continuous Levy to Employment Tax Liability of Certain Federal Contractors (Amendment 3371 and secs. 6330 and 6331 of the Code)

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.[432] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[433] and the IRS has provided both notice of intention to levy[434] and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice) [435] at least thirty days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[436]

The 30-day pre-levy notice requirements, the taxpayer's rights before, during, and following the CDP hearing, and the Federal payment levy program are discussed below.

Pre-levy notice requirements

The notice of intent to levy and the CDP notice must include a brief statement describing the following: (1) the statutory provisions and procedures for levy, (2) the administrative appeals available to the taxpayer, (3) the alternatives available to avoid levy, and (4) the provisions and procedures regarding redemption of levied property.[437] In addition, the collection due process notice must include the following: (1) the amount of the unpaid tax, and (2) the right to request a hearing during the 30-day period before the IRS serves the levy.

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[432] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[433] Sec. 6331(a).

[434] Sec. 6331(d).

[435] Sec. 6330. The administrative hearing is referred to as the CDP hearing.

[436] Sec. 6321.

[437] Sec. 6330(a)(3), 6331(d)(4). In practice, the notice of intent to levy and the collections due process notice is provided together in one document, Letter 1058, *Final Notice, Notice of Intent to Levy and Notice of Your Right to a Hearing*. Chief Counsel Advice Memorandum 2009-041 (November 28, 2008)

Upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a CDP hearing before the IRS Appeals Office.[438] Otherwise, the IRS will levy after expiration of 30 days from the notice.

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting assessment of tax without following the normal deficiency procedures.[439]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a state tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the 2-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the levy.[440]

CDP hearing

At the CDP hearing, the taxpayer may present defenses to collection as well as arguments disputing the merits of the underlying tax debt if the taxpayer had no prior opportunity to present such arguments.[441] In addition, CDP includes the right to negotiate an alternative form of payment, such as an offer-in-compromise, under which the IRS would accept less than the full amount, or an installment agreement under which payments in satisfaction of the debt may be made over time rather than in one lump sum, or some combination of such measures.[442] If a taxpayer exercises any of these rights in response to the notice of intent to levy, the IRS may not proceed with its levy.

After the CDP hearing, a taxpayer also has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination.[443] During this time period, the IRS may not proceed with its levy.

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[438] Sec. 6330(b).

[439] Secs. 6331(d)(3) and 6861.

[440] Sec. 6330(f).

[441] Sec. 6330(c).

[442] Sec. 6330(c)(2).

[443] Sec. 6330(d).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[444] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to Federal contractors that are delinquent on their tax obligations. The levy generally continues in effect until the liability is paid or the IRS releases the levy.[445]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or IRS releases the levy.

On the other hand, upon receipt of this information, the taxpayer may stay the levy action by requesting in writing a CDP hearing before the IRS Appeals Office. Also, after the CDP hearing, a taxpayer has a right to seek, within 30 days, judicial review in the U.S. Tax Court of the determination of the CDP hearing to ascertain whether the IRS abused its discretion in reaching its determination. During this time period, the IRS may not proceed with its levy.

Explanation of Provision

The provision allows the IRS to issue levies prior to a CDP hearing for Federal employment tax liabilities of Federal contractors identified under the Federal Payment Levy Program. When a levy is issued prior to a CDP hearing under this proposal, the taxpayer has an opportunity for a CDP hearing within a reasonable time after the levy.

Effective Date

The provision applies to levies issued after December 31, 2010.

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[444] Pub. L. No. 105-34.

[445] Sec. 6331(h). With respect to Federal payments to vendors of goods or services (not defined), the continuous levy may be up to 100 percent of each payment. Sec. 6331(h)(3).

E. Rollovers from Elective Deferral Plans to Roth Designated Accounts (Amendment 3374 and sec. 402A of the Code)

Present law

Individual retirement arrangements

General rules

There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[446] to which both deductible and nondeductible contributions may be made,[447] and Roth IRAs, to which only nondeductible contributions may be made.[448] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income. For a Roth IRA, all contributions are after-tax (no deduction is allowed) but, if certain requirements are satisfied, distributions are not includable in gross income.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth IRAs) for a taxable year is the lesser of a certain dollar amount ($5,000 for 2010)[449] or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. Thus for example, if an individual over age 50 contributes $6,000 to a Roth IRA for 2010 ($5,000 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for the year. In addition, deductible contributions to traditional IRAs and after tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2010 are: (1) for single taxpayers,

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[446] Sec. 408.

[447] Sec. 219.

[448] Sec. 408A.

[449] The dollar limit is indexed for inflation.

$109,000 to $124,000; (2) for married taxpayers filing joint returns, $167,000 to $177,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

Taxpayers generally may convert a traditional IRA into a Roth IRA. [450] A conversion may be accomplished by means of a rollover, trustee-to- trustee transfer, or account redesignation. Regardless of the means used to convert, any amount converted from a traditional IRA to a Roth IRA is treated as distributed from the traditional IRA and rolled over to the Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. Under special ordering rules, after-tax contributions are recovered before income.[451] The amount includible in income is also subject to the 10-percent early withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

Cash or deferred arrangements

Section 401(k) plans and section 403(b) plans

A qualified retirement plan[452] that is a profit-sharing plan may allow an employee may to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement. A plan with this feature is generally referred to as a section 401(k) plan. A section 403(b) plan may allow a similar salary reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.[453]

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[450] For taxable years beginning before January 1, 2010, such a conversion is not permitted to be made by a taxpayer whose modified adjusted gross income for the year of the distribution exceeds $100,000 (or who, if married, does not file jointly). For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed $100,000 (and who, if married, files jointly).

[451] Sec.408A(d)(4)

[452] Qualified retirement plans include plans qualified under section 401(a) and section 403(a) annuity plans.

[453] Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans.

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements generally are referred to as elective contributions and generally are excludable from gross income. There is a dollar limit on the aggregate amount of elective contributions that an employee is permitted to be contribute to either of these plans for a taxable year which is $16,500 for 2010. There is an additional catch up amount that employees over age 50 are allowed to contribute which is $5,500 for 2010.

Elective contributions under a section 401(k) plan are subject to distribution restrictions under the plan. Such contributions generally may only be distributed after attainment of age 59 1/2, death of the employee, termination of the plan, or severance from employment with the employer maintaining the plan. These contributions are also permitted to be distributed on account of hardship. These limitations also apply to certain other contributions to the plan except that such distributions cannot be distributed on account of hardship. Similar distribution restrictions apply to salary reduction contributions under section 403(b) plans.

Amounts under a profit sharing plan that are not subject to these specific distribution restrictions are distributable only as permitted under the plan terms. In order to meet the definition of profit -sharing plan, the plan may allow distribution of an amount contributed to a profit sharing plan after a fixed number of years, not less than two.[454]

Designated Roth accounts

A qualified retirement plan or a section 403(b) plan with a cash or deferred arrangement can include a Designated Roth program under which an employee is permitted to designate any elective contribution as a designated Roth contribution in lieu of making a pre-tax elective contribution. Although such a plan is permitted to offer only the opportunity to make pre-tax elective contributions, a plan that allows designated Roth contributions must offer a choice of both pre-tax elective contributions and designated Roth contributions.[455] The designated contributions are generally treated the same under the plan as pre-tax elective contributions (e.g. the nondiscrimination requirements and contribution limits) except a designated Roth contribution is not excluded from gross income.

All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). Any distribution from a designated Roth account (other than a qualified distribution) is taxable under section 402 by treating the designated Roth account as a separate contract for purpose of section 72. The distribution is included in the distributee's gross income to the extent allocable to income under the contract and excluded from gross income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis. The special basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts.

[454] Rev. Rul. 71-295, 1971, CB 184 and Treas. Reg. sec. 1.401(b)(1)(ii).

[455] Treas. Reg. sec.1.401(k)-1(f)(1)(i).

A qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after completion of a specified 5-year period and the satisfaction of one of three other requirements. The three other requirements are the same as the other requirements for a qualified distribution from a Roth account except that the first time home buyer provision does not apply.

Eligible rollover distributions from designated Roth accounts may only be rolled over tax free to another designated Roth account or a Roth IRA.

Rollovers from eligible retirement plans

An eligible rollover distribution from an eligible employer plan that is not from a designated Roth account may be rolled over to an eligible retirement plan that is not a Roth IRA or a designated Roth account. An eligible employer plan is a qualified retirement plan, a section 403(b) plan; and a "governmental section 457(b) plan.[456] In such a case, the distribution generally is not currently includible in the distributee's gross income. An eligible retirement plan means an individual retirement plan or an eligible employer plan. An eligible rollover distribution is any distribution from an eligible employer plan with certain exceptions. Distributions that are not eligible rollover distributions generally are certain periodic payments, any distribution to the extent the distribution is a minimum required distribution, and any distribution made on account of hardship of the employee.[457] Only an employee or a surviving spouse of an employee is allowed to rollover an eligible rollover distribution from an eligible employer plan to another eligible employer plan.[458]

Distributions from an eligible employer plan are also permitted to be rolled over into a Roth IRA, subject to the present law rules that apply to conversions from a traditional IRA into a Roth IRA.[459] Thus, a rollover from a eligible employer plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply. [460] In the case of a distribution and rollover of property, the amount of the distribution for purposes of determining the amount includable in

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[456] A governmental section 457(b) plan is an eligible section 457(b) plan maintained by a governmental employer described in section 457(e)(1)(A)

[457] Sec. 402(c)(4).

[458] Section 402(c)(10) allows nonspouse beneficiaries to make a direct rollover to an IRA but not another eligible employer plan.

[459] For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed $100,000 (and who, if married, files jointly).

[460] Prior to enactment of section 824 of the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780) (PPA '06), an eligible rollover distribution from an eligible employer plan not made from a designated Roth account could be rolled over to a non-Roth IRA and then converted to a Roth IRA, but could not be rolled over to a Roth IRA without an intervening rollover to a non-Roth IRA followed by a conversion to a Roth IRA. See Notice 2008-30, 2008-12 I.R.B. 638.

gross income is generally the fair market value of the property on the date of the distribution.[461] The special rules relating to net unrealized appreciation and certain optional methods for calculating tax available to participants born on or before January 1, 1936 are not applicable.[462] A special recapture rule relating to the 10-precent additional tax on early distributions applies for distributions made from a Roth IRA within a specified 5-year period after a rollover. [463]

Special rule for 2010 conversions or rollovers

In the case of a rollover from a tax-qualified retirement plan (other than a designated Roth account) into a Roth IRA, unless the taxpayer elects to include the distribution in income in 2010, any amount otherwise required to be included in gross income for the 2010 taxable year is not included in that taxable year but is instead included in gross income in equal amounts for the 2011 and 2012 taxable years. The same rule applies to a conversion of a traditional IRA into a Roth IRA in 2010. However, in both cases, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from a Roth IRA within a specified 5-year period after a rollover.

Description of Provision

Under the provision, if a section 401(k) plan, section 403(b) plan, or governmental section 457(b) plan[464] has a qualified designated Roth contribution program, a distribution to an employee (or a surviving spouse) from an account under the plan that is not a designated Roth account is permitted to be rolled over into a designated Roth account under the plan for the individual. However, a plan that does not otherwise have a designated Roth program is not permitted to establish designated Roth accounts solely to accept these rollover contributions. Thus, for example, a qualified employer plan that does not include a qualified cash or deferred arrangement with a designated Roth program cannot allow rollover contributions from accounts that are not designated Roth accounts to designated Roth accounts established solely for purposes of accepting these rollover contributions. Further, the distribution to be rolled over must be otherwise allowed under the plan. For example, an amount under a section 401(k) plan subject to distribution restrictions cannot be rolled over to a designated Roth account under this provision. However, if an employer decides to expand its distribution options beyond those currently allowed under its plan, such as by adding in-service distributions or distributions prior to normal retirement age, in order to allow employees to make the rollover contributions permitted under this provision, the plan may condition eligibility for such a new distribution option on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.

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[461] Treas. Reg. sec. 1.402(a)-1(a)(iii).

[462] Notice 2009-75, 2009-39 IRB 436.

[463] Sec. 408A(d)(3)(F), Treas. Reg. sec. 1.408A-6 A-5, and Notice 2008-30, Q&A-3

[464] The bill includes a provision which adds governmental section 457(b) plans to the plans that are permitted to include a designated Roth program.

In the case of a permitted rollover contribution to a designated Roth account under this provision, the individual must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA. Thus the special rule for distributions from eligible retirement plans (other than from designated Roth accounts) that are contributed to a Roth IRA in 2010 applies for these rollover contributions to a designated Roth account. Under this special rule, the taxpayer is allowed to include the amount in income equal amounts in 2011 and 2012. The special recapture rule for the 10-percent early distribution tax also applies if distributions are made from the designated Roth account in the relevant 5 year period.

This rollover contribution may be accomplished at the election of the employee (or surviving spouse) through a direct rollover (operationally through a transfer of assets from the account that is not a designated Roth account to the designated Roth account). However, such a direct rollover is only permitted if the employee (or surviving spouse) is eligible for a distribution in that amount and in that form (if property transferred) and the distribution is an eligible rollover distribution. If the direct rollover is accomplished by a transfer of property to the designated Roth account (rather than cash), the amount of the distribution is the fair market value of the property on the date of the transfer.

A plan that includes a designated Roth program is permitted but not required to allow employees (and surviving spouses) to make the rollover contribution described in this provision to a designated Roth account. If a plan allows these rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature. It is intended that the IRS will provide employers with a remedial amendment period that allows the employers to offer this option to employees (and surviving spouses) for distributions during 2010 and then have sufficient time to amend the plan to reflect this feature.

Effective Date

The provision is effective for distributions made after the date of enactment.

F. Election to Temporarily Utilize Unused AMT Credits Determined by Domestic investment (Amendment 3382 and sec. 53 of the Code)

Present Law

Minimum tax credits

If a corporation is subject to the alternative minimum tax ("AMT") in any taxable year, the amount of AMT imposed is allowed as a credit ("minimum tax credit") in a subsequent taxable year to the extent the corporation's regular tax liability in the subsequent year exceeds its tentative minimum tax.[465] Minimum tax credits may be carried forward indefinitely until utilized.

Election to claim minimum tax credits in lieu of bonus depreciation

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect, for its first taxable year ending after December 31, 2008 and each subsequent taxable year, to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for "extension property."[466] "Extension property" is property that is eligible qualified property solely by reason of the extension of the additional first-year depreciation deduction pursuant to the amendments made by section 1201(a) of the American Recovery and Reinvestment Tax Act of 2009.[467] Eligible qualified property generally is property placed in service during 2009 (2010 in the case of certain longer-lived and transportation property) that is otherwise eligible for the additional first-year depreciation deduction.

A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits.[468] The increase in the allowable credits is treated as refundable for purposes of this provision. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

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[465] Sec. 53.

[466] Sec. 168(k)(4). In the case of an electing corporation that is a partner in a partnership, the corporate partner's distributive share of partnership items is determined as if section 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property.

[467] Pub. L. No. 111-5, the American Recovery and Reinvestment Tax Act of 2009, extended the additional first-year depreciation deduction to apply to qualified property acquired and placed in service after December 31, 2008 and before January 1, 2010 (January 1, 2011, for certain longer-lived and transportation property). See discussion above.

[468] Special rules apply to an applicable partnership.

The research credit or minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation[469] for certain eligible qualified property that could be claimed absent the election. The bonus depreciation amount is limited to the lesser of: (1) $30 million, or (2) 6 percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006 and minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

Extended net operating loss carryback period

A net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.[470] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[471]

With respect to a NOL for a single taxable year beginning or ending in either 2008 or 2009, a taxpayer generally may elect to increase the present-law carryback period for such NOL from two years to any whole number of years elected by the taxpayer which is more than two and less than six.[472] The amount of NOL that may be carried back to the fifth taxable year preceding the loss year is limited to 50 percent of taxable income for such taxable year (computed without regard to the NOL for the loss year or any taxable year thereafter).[473] The amount of the NOL otherwise carried to taxable years subsequent to such fifth taxable year is adjusted to take into account that the NOL could offset only 50 percent of the taxable income in such year.

Explanation of Provision

A corporation may elect to increase the AMT liability limitation amount under section 53(c) for a taxable year beginning in 2010[474] by the AMT credit adjustment amount. The AMT

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[469] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

[470] Sec. 172(b)(1)(A). Different carryback periods apply with respect to NOLs arising in certain special circumstances.

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

[472] Sec. 172(b)(1)(H).

[473] The limitation does not apply to the applicable 2008 NOL of an eligible small business with respect to which an election is made (either before or after the date of enactment of the bill) under the provision as presently in effect.

[474] The provision does not apply to any taxable year that begins after December 31, 2010.

credit adjustment amount is an amount equal to the lesser of (i) 50 percent of the taxpayer's minimum tax credit determined under section 53(b) for the taxable year, or (ii) 10 percent of the taxpayer's new domestic investment made during the taxable year.[475]

Under the provision, new domestic investment is the cost of qualified property (as defined in section 168(k)(2)(A)(i)),[476] the original use of which commences with the taxpayer during the taxable year and which is placed in service in the United States by the taxpayer during such taxable year. A taxpayer that makes an election under this provision includes in its new domestic investments, its allocable share of any new domestic investments made by a partnership in which the taxpayer owns (directly or indirectly) more than 90 percent of the capital and profits interest at all times during the taxable year for which the election is in effect.

The amount of increase in the minimum tax credit allowed by reason of the election is treated as a refundable credit. The adjustment of overpayment of estimated taxes by a corporation under section 6425 may be increased by the AMT credit adjustment amount.

A taxpayer may not make both the election under this provision and the election under section 172(b)(1)(H). Accordingly, the provision provides that a taxpayer that has previously made an election under section 172(b)(1)(H) is deemed to have revoked such election by making the election under this section.

The Secretary is to prescribe the time and manner for making the election. Prior to the Secretary prescribing such guidance, a taxpayer will be treated as having made a valid election by providing written notification to the Secretary and the Commissioner of the Internal Revenue of such election.[477] Once made, an election under this provision may be revoked only with prior consent of the Secretary.

The Secretary is authorized to issue regulations as necessary to carry out the provision, including to prevent fraud and abuse with respect to the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

[475] For all elections under this provision, the common parent of a group of corporations filing a consolidated return makes the election, which is binding on all such corporations.

[476] Sec. 168(k)(2)(A)(i) defines "qualified property" as property that--(1) has a recovery period of 20 years or less, (2) is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to section 168(k)(2), (3) is water utility property, or (4) is qualified leasehold improvement property (defined in section 168(k)(3)).

[477] If a taxpayer makes the election prior to the Secretary issuing guidance prescribing the time and manner of making the election, it is intended that the written information include sufficient information for the Secretary to validate the taxpayer's eligibility to claim the credit and the amount of the increased credit claimed.

G. Information Reporting for Rental Property Expense Payments (Amendment 3382 and sec. 6041 of the Code)

Present Law

Real estate rentals present one of the sectors of the economy for which there is currently little or no information reporting, despite the existence of a variety of information reporting requirements under present law.[478] These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete.

The primary provision governing information reporting by payors requires an information return by every person engaged in a trade or business who makes payments to any one payee aggregating $600 or more in any taxable year in the course of that payor's trade or business.[479] Payments subject to reporting include fixed or determinable income or compensation, but do not include payments for goods or certain enumerated types of payments that are subject to other specific reporting requirements.[480] The payor is required to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor.[481] The regulations generally except from reporting payments to corporations, exempt organizations, governmental entities, international organizations, or retirement plans.[482] Additionally, the requirement that businesses report certain fixed or determinable payments of income or gain, by its terms, is not applicable to persons engaged in a passive investment activity. Thus, a taxpayer whose rental real estate activity is a trade or business is subject to this reporting requirement, but a taxpayer whose rental real estate activity is not considered a trade or business is not subject to such requirement.

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[478] Secs. 6031through 6060.

[479] Sec. 6041(a). The information return is generally submitted electronically as a Form 1096 and Form 1099, although certain payments to beneficiaries or employees may require use of Forms W-3 and W-2, respectively. Treas. Reg. sec. 1.6041-1(a)(2).

[480] Sec. 6041(a) requires reporting as to "other fixed or determinable gains, profits, and income (other than payments to which section 6042(a)(1), 6044(a)(1), 6047(c), 6049(a) or 6050N(a) applies and other than payments with respect to which a statement is required under authority of section 6042(a), 6044(a)(2) or 6045)[.]" The payments thus excepted include most interest, royalties, and dividends.

[481] Sec. 6041(d). Specifically, the recipient of the payment is required to provide a Form W-9 to the payor, which enables the payee to provide the recipient of the payment with an annual statement showing the aggregate payments made and contact information for the payor. If a Form W-9 is not provided, the payor is required to "backup withhold" tax at a rate of 28 percent of the gross amount of the payment unless the payee has otherwise established that the income is exempt from backup withholding. The backup withholding tax may be credited by the payee against regular income tax liability, i.e., it is effectively an advance payment of tax, similar to the withholding of tax from wages. This combination of reporting and backup withholding is designed to ensure that U.S. persons pay an appropriate amount of tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

[482] Treas. Reg. sec. 1.6041-3(p). Certain for-profit health provider corporations are not covered by this general exception, including those organizations providing billing services for such companies.

Persons engaged in certain real estate transactions generally must report the gross proceeds paid from such transactions.[483] A real estate transaction is defined by regulation as a sale or exchange of reportable real estate, which in turn is defined to include present or future ownership interests, but not most leaseholds.[484]

In addition, financial institutions are required to report to both taxpayers and the IRS the amount of interest taxpayers paid during the year on mortgages they held on their rental properties.[485]

Failure to comply with the information reporting requirements is subject to penalties, which may include a penalty for failure to file the information return,[486] for failure to furnish payee statements,[487] or for failure to comply with other various reporting requirements.[488]

Explanation of Provision

The statute provides that recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider. Exceptions to this reporting requirement are made for taxpayers (including members of the military) who rent their principal residence on a temporary basis. In addition, the provision does not require reporting if to do so would constitute a hardship or if the rental income received is minimal. Whether a hardship or de minimis exception is met is determined by the Secretary in accordance with regulations.

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[483] Sec. 6045(e) requires reporting by real estate brokers, persons responsible for closing and others designed in regulations, but excepts from reporting sales of principal residences for $250,000 or less ($500,000 for married persons).

[484] Treas. Reg. sec. 1.6045-4(b)(2) defines reportable real estate to include rights to possession or use of real estate only if such rights were created prior to January 1, 1991, and had a remaining term of at least 30 years.

[485] Sec. 6050H. This information is provided on Form 1098.

[486] Sec. 6721. The penalty for the failure to file an information return generally is $50 for each return for which such failure occurs. The total penalty imposed on a person for all failures during a calendar year cannot exceed $250,000. Additionally, special rules apply to reduce the per-failure and maximum penalty where the failure is corrected within a specified period.

[487] Sec. 6722. The penalty for failure to provide a correct payee statement is $50 for each statement with respect to which such failure occurs, with the total penalty for a calendar year not to exceed $100,000. Special rules apply that increase the per-statement and total penalties where there is intentional disregard of the requirement to furnish a payee statement.

[488] Sec. 6723. The penalty for failure to timely comply with a specified information reporting requirement is $50 per failure, not to exceed $100,000 for a calendar year.

Effective Date

The provision applies to payments made after December 31, 2010.

H. Extension of Time to Issue Gulf Opportunity Zone Bonds (Amendment 3383 and sec. 1400N(a) of the Code)

Present Law

The Gulf Opportunity Zone Act of 2005 (the "Act") authorizes Alabama, Louisiana, and Mississippi (or any political subdivision of those States) to issue qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone ("GO Zone bonds"). GO Zone bonds are not subject to the State volume cap. Rather, the maximum aggregate amount of GO Zone bonds that may be issued in any eligible State is limited to $2,500 multiplied by the population of the respective State within the Gulf Opportunity Zone. GO Zone bonds must be issued before January 1, 2011.

GO Zone bonds are treated as exempt facility bonds or qualified mortgage bonds. In general, for purposes of the exempt facility bonds, qualified project costs are the cost of any qualified residential rental project located in the GO Zone, the cost of acquisition, construction, reconstruction and renovation of nonresidential real property (including fixed improvements associated with such property) located in the GO Zone, and the cost of acquisition, construction, reconstruction and renovation of public utility property (as defined in section 168(i)(10)) located in the GO Zone (sec. 1400N(a)(4)). GO Zone bonds cannot be used for movable fixtures or equipment (sec. 1400N(a)(3)(B)). Nor can GO Zone bonds be used to provide any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or any store the principal businesses of which is the sale of alcoholic beverages for consumption off premises (sec. 1400N(a)(2)(E) and sec. 144(c)(6)(B)).

GO Zone bonds are treated as qualified mortgage bonds if the issue meets the general requirements of a qualified mortgage issue, with certain modifications, and the residences financed with such bonds are located in the GO Zone.

Explanation of Provision

The provision extends, for one additional year, the deadline by which GO Zone bonds must be issued, from January 1, 2011 to January 1, 2012.

Effective Date

The provision is effective on the date of enactment.

I. Application of Levy to Payments to Federal Vendors Relating to Property (Amendment 3383 and sec. 6331 of the Code)

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property or rights to property to pay the taxpayer's tax liability.[489] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[490] and the IRS has provided both notice of intention to levy[491] and notice of the right to an administrative hearing (referred to as a collections due process notice or "CDP" notice) [492] at least 30 days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[493]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable in permitting assessment of tax without following the normal deficiency procedures.[494]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a federal tax liability from a state tax refund. In addition, a levy issued to collect federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. The taxpayer, however, in each of these three cases, is provided an opportunity for a hearing within a reasonable period of time after the issuance of the levy.[495]

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[489] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[490] Sec. 6331(a).

[491] Sec. 6331(d).

[492] Sec. 6330. The administrative hearing is referred to as the CDP hearing.

[493] Sec. 6321.

[494] Secs. 6331(d)(3) and 6861.

[495] Sec. 6330(f).

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[496] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of certain "specified payments," such as government payments to federal contractors that are delinquent on their tax obligations. With respect to Federal payments to vendors of goods or services, the continuous levy may be up to 100 percent of each payment.[497] The term "goods or services" is not defined in the statute. The levy (either 15 percent or 100 percent) generally continues in effect until the liability is paid or the IRS releases the levy.

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and federal wage records. When the records match, the delinquent taxpayer is provided both notice of intention to levy and notice of the right to the CDP hearing 30 days before the levy is made. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy its federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or IRS releases the levy.

Explanation of Provision

The provision amends section 6331(h)(3) to add "property" to "goods or services" to allow the IRS can levy 100 percent of any payment due to a Federal vendor with unpaid Federal tax liabilities, including payments made for the sale or lease of real estate and other types of property not considered "goods or services."

Effective Date

The provision applies to levies approved after the date of enactment.

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[496] Pub. L. No. 105-34.

[497] Sec. 6331(h)(3).

J. Credit for Nonbusiness Energy Property (Amendment 3397 and sec. 25C of the Code)

Present Law

In general

Section 25C provides a 30-percent credit for the purchase of qualified energy efficiency improvements to the envelope of existing homes. Additionally, section 25C provides a 30 percent credit for the purchase of (1) qualified natural gas, propane, or oil furnace or hot water boilers, (2) qualified energy efficient property, and (3) advanced main air circulating fans.

The credit applies to expenditures made after December 31, 2008 for property placed in service after December 31, 2008, and prior to January 1, 2011.[498] The aggregate amount of the credit allowed for a taxpayer for taxable years beginning in 2009 and 2010 is $1,500.

Building envelope improvements

A qualified energy efficiency improvement is any energy efficiency building envelope component (1) that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code[499] as supplemented and as in effect on August 8, 2005 (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling and which meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors provided such component has a U-factor and a seasonal heat gain coefficient ("SHGC") of 0.3 or less; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

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[498] With the exception of biomass fuel property, property placed in service after December 31, 2008 and prior to February 17, 2009 qualifies for the new 30 percent credit rate (and $1,500 aggregate cap) if it met the efficiency standards of prior law for property placed in service during 2009. Biomass fuel property placed in service at any point in 2009 is governed by the new efficiency standard.

[499] This reference to the 2000 International Energy Conservation Code is superseded by the additional requirements described in the paragraph below regarding building envelope components.

Other eligible property

Qualified natural gas, propane, or oil furnace or hot water boilers

A qualified natural gas, propane, or oil hot water boiler is a natural gas, propane, or oil hot water boiler with an annual fuel utilization efficiency rate of at least 90. A qualified natural gas or propane furnace is a natural gas or propane furnace with an annual fuel utilization efficiency rate of at least 95. A qualified oil furnace is an oil furnace with an annual fuel utilization efficiency rate of at least 90.

Qualified energy-efficient property

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier of Consortium for Energy Efficiency, as in effect on January 1, 2009,[500] (3) a central air conditioner with energy efficiency of at least the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009,[501] (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent as measured using a lower heating value. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants, grasses, residues, and fibers).

Advanced main air circulating fan

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

Additional rules

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used

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[500] These standards are a seasonal energy efficiency ratio ("SEER") greater than or equal to 15, an energy efficiency ratio ("EER") greater than or equal to 12.5, and heating seasonal performance factor ("HSPF") greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

[501] These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

Explanation of Provision

The provision modifies the standards for exterior windows (including skylights) and doors (other than garage doors) to provide that any such component placed in service after 90 days after the date of enactment of this Act shall meet the criteria for such component established by the 2010 Energy Star Program Requirements for Residential Windows, Doors, and Skylights, Version 5.0 (or any subsequent version of such requirements which is in effect after January 4, 2010). For exterior windows (including skylights) and doors (other than garage doors) placed in service after the date of enactment of this Act but before 90 days after the date of enactment of this Act, such component must meet the aforementioned Energy Star criteria for such component or meet the present law criteria of a U factor of 0.30 or less and a SHGC of 0.30 or less. The energy efficiency requirements for garage doors are unchanged by the Act. Such components must continue to meet the present law criteria of a U factor of 0.30 or less and a SHGC of 0.30 or less to be eligible.

Effective Date

The provision applies to property placed in service after the date of enactment.

K. Participants in Government Section 457 Plans Allowed to Treat Elective Deferrals as Roth Contributions (Amendment 3397 and sec. 402A of the Code)

Present Law

Section 401(k) plans and section 403(b) plans are permitted to have qualified Roth contribution programs under which participants may elect to make non-excludable contributions to "designated Roth accounts" and, if certain conditions are met, to exclude from gross income distributions from these accounts.

A qualified Roth contribution program is a program under which a participant may elect to make designated Roth contributions in lieu of all or a portion of the elective deferrals that he or she otherwise would be eligible to make under the applicable retirement plan. To qualify as a qualified Roth contribution program a plan must: (1) establish a separate designated Roth account for the designated Roth contributions of each participants (and for the earnings allocable to these contributions); (2) maintain separate records for each account; and (3) refrain from allocating to the designated Roth account amounts from non-designated Roth accounts.

Generally, if an "applicable retirement plan" includes a qualified Roth contribution program then any contribution that a participant makes under the program is treated as an "elective deferral," but is not excludable from gross income.[502] For purposes of the qualified Roth contribution program rules, the term "applicable retirement plan" means: (1) an employee's trust described in section 401(a) which is tax-exempt under section 501(a);[503] and (2) a plan under which amounts are contributed by an individual's employer for a section 403(b) annuity contract.[504] An "elective deferral" is any deferral described in: (1) section 402(g)(3)(A) (employer contributions to section 401(k) plans not includible in employee's gross income); or (2) section 402(g)(3)(C) (employer contributions to purchase an annuity contract under a section 403(b) salary reduction agreement).

Explanation of Provision

The provision amends the definition of "applicable retirement plan" to include eligible deferred compensation plans (as defined under section 457(b)) maintained by a State, political subdivision of a State, an agency or instrumentality of a State, or an agency or instrumentality of a political subdivision of a State ("governmental 457(b) plans"). The provision also amends the definition of "elective deferral" in section 402A to include amounts deferred under governmental 457(b) plan.

[502] Sec. 402A(a)(1).

[503] That is, a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries.

[504] That is, an annuity purchased by a section 501(c)(3) organization or a public school.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2010.

L. Extension of Special Allowance for Certain Property (Amendment 3411 and sec. 15345 of Pub. L. No. 110-246)

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year generally is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.[505] In general, the recovery periods for real property are 39 years for non-residential real property and 27.5 years for residential rental property. The depreciation method for real property is the straight-line method.

Under MACRS, the entire basis of depreciable property is recovered by the taxpayer over the applicable recovery period; there is no need to estimate salvage value. Further, under MACRS, the applicable recovery period need not (and typically does not) correspond to the actual economic life of the asset subject to depreciation. However, MACRS generally provides for longer recovery periods for longer lived assets.

Special allowance for qualified Recovery Assistance property

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified Recovery Assistance property placed in service on or before December 31, 2008 (December 31, 2009, in the case of nonresidential real property and residential rental property).[506] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits.[507] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of

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[505] For certain property, including tangible property used predominantly outside of the United States, tax-exempt use property, tax-exempt bond-financed property, and certain other property, the MACRS "alternative depreciation system" of section 168(g) applies, generally increasing recovery periods and requiring straight-line depreciation.

[506] Secs. 15345(a)(1) and (d)(1) of the Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-246.

[507] Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Property is considered qualified Recovery Assistance property and eligible for the additional first-year depreciation deduction if it meets all of the following requirements: (1) The property must be property to which the general rules of the MACRS apply with (a) an applicable recovery period of 20 years or less, (b) computer software other than computer software covered by section 197, (c) water utility property (as defined in section 168(e)(5)), (d) certain leasehold improvement property, or (e) certain nonresidential real property and residential rental property; (2) substantially all of the use of such property must be in the Kansas Disaster Area and in the active conduct of a trade or business by the taxpayer in the Kansas Disaster Area;[508] (3) the original use of the property in the Kansas Disaster Area must commence with the taxpayer on or after May 5, 2007;[509] and (4) the property must be acquired by purchase (as defined under section 179(d)) by the taxpayer on or after May 5, 2007 and placed in service on or before December 31, 2008 (December 31, 2009, for qualifying nonresidential real property and residential rental property). Property does not qualify if a binding written contract for the acquisition of such property was in effect before May 5, 2007. However, property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to May 5, 2007.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after May 4, 2007, and before January 1, 2009, and the property is placed in service on or before December 31, 2008 (and all other requirements are met). In the case of qualified nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2009. 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.

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[508] For purposes of this section, the term "Kansas Disaster Area" means an area with respect to which a major disaster has been declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (FEMA-1699-DR, as in effect on the date of the enactment of this Act) by reason of severe storms and tornados beginning on May 4, 2007, and determined by the President to warrant individual or individual and public assistance from the Federal Government under such Act with respect to damages attributable to such storms and tornados. Sec. 15345(b) of Pub. L. No. 110-246.

[509] Used property may constitute qualified property so long as it has not previously been used within the Kansas Disaster Area. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Kansas Disaster Area began with the taxpayer would satisfy the "original use" requirement. See Treasury Regulation sec. 1.48-2, Example 5.

Explanation of Provision

The provision extends the additional first-year depreciation deduction for one year to apply to qualified Recovery Assistance property that is nonresidential real property or residential rental property acquired and placed in service on or before December 31, 2010.

Effective Date

The provision applies to property placed in service after December 31, 2009.

M. Application of Bad Checks Penalty to Electronic Payments (Amendment 3411 and sec. 6657 of the Code)

Present Law

In general

Taxpayers may pay their tax liability by "any commercially acceptable means" that the Secretary deems appropriate.[510] For example, taxpayers may pay their taxes by check, money order, debit or credit card, electronic funds withdrawal,[511] as well as by phone or internet using the Electronic Federal Tax Payment System ("EFTPS").[512] EFTPS is a tax payment system provided free by the Treasury, available to businesses and individuals who enroll. An enrolled taxpayer can pay all of its Federal taxes using EFTPS. Individuals can pay quarterly estimated taxes electronically using EFTPS, and can make payments weekly, monthly, or quarterly. Both business and individual payments can be scheduled in advance. In addition, certain excise taxes are required to be paid by EFTPS.[513] The Code authorizes the Secretary to specify when and how the new media could be used to satisfy tax obligations.[514] Regulations permit tax payments by credit or debit card, but specify that the taxpayer's use of a credit or debit card to pay taxes must be voluntary.[515] The Secretary is also authorized to enter into contracts to obtain services related to receiving payment if it is cost-beneficial to the government, but may not pay "any fee or other consideration under such contracts for the use of credit, debit or charge cards for the payment of taxes," such as the convenience fees charged for electronic tax payments.[516]

Bad check penalty

Any taxpayer who attempts to satisfy a tax liability with a check or money order that is not duly paid is subject to a penalty equal to either (1) two percent of the amount of the bad check or money order or (2) if the amount of the bad check or money order is less than $1,250, $25 or the amount of the check or money order, whichever is less.[517] The penalty is not

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[510] Sec. 6311(a).

[511] Treas. Reg. sec. 301.6311-2(a)(2) provides that guidance on electronic funds transfers other than credit or debit cards is provided in regulations under section 6302, which defines electronic funds transfers generally to include any transfer of funds other than by check, draft or similar paper instrument, if initiated through an electronic media to instruct a financial institution or intermediary to debit or credit an account.

[512] Section 6311(b) lists some of these examples. Treas. Reg. secs. 301.6311-1(b)(1) and 301.6311-2(b) provide that the underlying tax obligation is not considered satisfied until the check or money order is paid or the electronic payment has been authorized by the relevant financial institution and the payment actually received.

[513] Secs. 5061(e) and 5703(b).

[514] Sec. 6311(d).

[515] Treas. Reg. sec. 301.6311-2(a)(1).

[516] Sec. 6311(d)(2); Treas. Reg. sec. 301.6311-2(f).

[517] Sec. 6657.

applicable if the taxpayer establishes that payment was tendered in good faith and with reasonable cause to believe it would be paid.

The Code provides that this penalty applies only to "any check or money order," notwithstanding the fact that electronic funds transfers from a bank account, debit cards, and credit cards are all commercially acceptable means by which to make a payment. There is currently no bad check penalty that covers instruments of payment other than checks or money orders.

Explanation of Provision

The provision expands the bad check penalty to cover all commercially acceptable instruments of payment that are not duly paid.

Effective Date

The provision applies to instruments tendered after the date of enactment.

N. Energy Efficient Appliance Credit (Amendment 3416 and sec. 45M of the Code)

Present Law

In general

A credit is allowed for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators. The credit is part of the general business credit.

The credits are as follows:

Dishwashers

$45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle, and

$75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes washers

$75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed a 8.0 water consumption factor, and

$125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,

$150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009 or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor, and

$250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor.

Refrigerators

$50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

$75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but no more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

$100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009 or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards, and

$200 in the case of a refrigerator manufactured in calendar year 2008, 2009 or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards.

Definitions

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

The term "modified energy factor" means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.

The term "gallons per cycle" means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term "water consumption factor" means, with respect to a clothes washer, the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

Other rules

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the two prior calendar years for each category of appliance. The aggregate credit amount allowed with respect to a taxpayer for all taxable years beginning after December 31, 2007 may not exceed $75 million, with the exception that the $200 refrigerator credit and the $250 clothes washer credit are not limited. Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

Explanation of Provision

The provision provides that a taxpayer may elect to receive a grant, in lieu of the present law tax credit, equal to 85 percent of the amount of the credit otherwise determined.

Effective Date

The provision is effective with respect to taxable years that include the last day of calendar year 2009 or the last day of calendar year 2010.