

## MEMORANDUM

From: Finance Committee Tax Staff  
Date: November 16, 2005  
Re: Summary of Tax Relief Act of 2005

### I. Hurricane Tax Relief

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

**Bonus Depreciation.** Current law allows businesses to recover the costs of new equipment over the economic life of the property. The bonus depreciation proposal would permit businesses to expense 50 percent of the cost of new equipment placed in service in the Gulf Opportunity Zone in the first year. Property which qualified for bonus depreciation would include certain commercial and residential rental real estate expenditures as well as equipment. Investments would not be subject to the AMT depreciation preference. This provision would apply to property placed in service in the Gulf Opportunity Zone through 2007 (2008 for real property). The proposal is estimated to cost \$2.9 billion over five years.

**Increase in Expensing for Small Businesses.** Current law permits certain small businesses to deduct up to \$100,000 of the cost of property used in the business. The proposal would double this amount to \$200,000 for qualifying expenditures made in the disaster area through 2007. This provision would also increase the level of investment at which benefits phase out from \$400,000 to \$1 million of qualifying purchases, thus allowing more businesses to use this tax benefit in rebuilding. The proposal is estimated to cost \$31 million over five years.

**Additional Private Activity Bond Authority.** The proposal authorizes the issuance of qualified private activity bonds by the States of Alabama, Louisiana, or Mississippi, or any of their political subdivisions in excess of their current private activity bond limits. The maximum aggregate face amount of these “GO Zone bonds” would be limited to an amount equal to \$2,500 per person in each of Alabama, Louisiana, and Mississippi’s respective Gulf Opportunity Zones as based on 2004 population estimates. Bond interest on the GO Zone bonds would not be subject to the AMT. The proposal is estimated to cost \$440 million over five years.

**Additional Advance Refunding for Bonds.** The proposal permits an additional advance refunding of certain governmental bonds issued by the States of Alabama, Louisiana, or Mississippi, or any of their political subdivisions and certain 501(c)(3) bonds prior to January 1, 2007. The proposal is estimated to cost \$234 million over five years.

**Increase in Funding for Low Income Housing.** Under current law, States receive allocations of low-income housing tax credits based on population. The proposal allows States to allocate volumes of additional housing credit amounts in years 2006 to 2009 of 3 times the normal allocation with respect to the population in each State's GO Zone (for Alabama, Mississippi, and Louisiana) and designates the GO Zone as a difficult to develop area. The proposal is estimated to cost \$299 million over five years.

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

**New Markets Tax Credit.** The proposal provides \$1 billion from 2005 through 2007 in New Market's Tax Credit authority and to Community Development Entities with hurricane rebuilding and recovery as a significant mission. The proposal is estimated to cost \$166 million over five years.

**Net Operating Loss Carryback.** The proposal extends the net operating loss carryback period from 2 to 5 years for net operating losses attributable to (i) new investment and repairing existing investment in the areas damaged by Hurricane Katrina; (ii) business casualty losses caused by Hurricane Katrina; and (iii) moving expenses and temporary housing expenses for employees working in areas damaged by Hurricane Katrina. The proposal is estimated to cost \$923 million over five years.

**Public Utility Casualty Loss Carryback.** Taxpayers with casualty losses associated with public utility property caused by Hurricane Katrina can elect to either (i) carryback a net operating loss attributable to certain casualty losses 10 years; or (ii) treat certain casualty losses as having occurred 5 years prior to the disaster under the proposal. These proposals are estimated to cost \$235 million over five years.

**Increased Expensing and NOL Carryback for Qualified Timber Property.** Under current law, taxpayers may only deduct \$10,000 of reforestation cost. The proposal raises the limit to \$20,000 and allows losses to be carried back for 5 years, rather than the current 2-year carryback. The proposal only applies to taxpayers owning less than 500 acres of timber in the Katrina, Rita, and Wilma Zones. The proposals are estimated to cost \$3 million over five years.

**Partial Expensing for Demolition and Cleanup Costs.** Under the proposal, 50 percent of the costs (that would otherwise be capitalized) related to site cleanup and demolition would be deductible by businesses. The proposal is estimated to cost \$122 million over five years.

**Expensing to Promote Cleanup of Brownfields.** The proposal extends the deductibility of costs of cleaning up Brownfields in the Katrina GO Zone for 2 years and allows expensing for the cleanup of petroleum products in the Katrina GO Zone. The proposal is estimated to cost \$43 million over five years.

**Employee Retention Credit:** In the Katrina Emergency Tax Relief Act of 2005 we provided a 40 percent tax credit for wages paid up to \$6,000 if paid after August 28, 2005, and before December 31, 2005, by employers located in the Katrina GO Zone. The proposal modifies the tax credit so that the provision applies without regard to the size of the employer. The proposal is estimated to cost \$90 million over five years.

**Hope Scholarship and Lifetime Learning Credit.** Current law allows a Hope Scholarship Credit in first two years of postsecondary school equal to 100% of the first \$1,000 of qualified tuition and related expenses, and 50% of the next \$1,000 for a maximum of \$1,500. There is also a Lifetime Learning Credit available to students enrolled in one or more courses at the undergraduate or graduate level (whether or not pursuing a degree), equal to 20% of the first \$10,000 in qualified tuition and related expenses. The credits phase out between \$42,000 and \$52,000 (single filers) and \$85,000 and \$105,000 (married filing jointly) for 2004 (adjusted for inflation thereafter). For each year, though, taxpayers may only claim the Hope, Lifetime, or Qualified Tuition Deduction with respect to an eligible student. The provision doubles the Hope Credit dollar amounts so the maximum credit would be \$3,000, and doubles the Lifetime Learning Credit percentage from 20% to 40%, for a maximum Lifetime Learning Credit of \$4,000. Room and board, books and fees would also be considered qualified expenses. Cost: \$55 million over five years.

**Relax Restrictions on Mortgage Revenue Bonds.** Mortgage revenue bonds are tax-exempt bonds that state and local governments generally issue through housing finance agencies. The proceeds from the bonds are used to fund below-market interest rate mortgages for certain first-time homebuyers meeting income and purchase price restrictions. The proposal would provide greater access to mortgage revenue bond proceeds with respect to Katrina by lifting the first-time homeowner requirement and by allowing up to \$150,000 in mortgage revenue bond proceeds to be used for repairs through December 31, 2010. The proposal would also relax the income and purchase price restrictions with respect to mortgage revenue bonds funded with the proposal's Katrina GO Zone bonds. The proposal is estimated to cost \$20 million over five years.

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

- **Relax Restrictions on Mortgage Revenue Bonds.** Mortgage revenue bonds are tax-exempt bonds that State and local governments generally issue through housing finance agencies. The proceeds from the bonds are used to fund below-market interest rate mortgages for certain first-time homebuyers meeting income and purchase price restrictions. The provision allows greater access to mortgage revenue

bond proceeds by relaxing the income and purchase price limitations and lifting the first-time homeowner requirement through December 31, 2010, for homes in certain areas damaged by Hurricanes Rita and Wilma. In addition, the provision allows up to \$150,000 of the loan proceeds to be used for hurricane-related repairs to damaged homes. The proposal is estimated to cost \$20 million over five years.

- **Early Withdrawals from Retirement Plans.** Present law discourages distributions from tax-preferred retirement plans with penalties and other limitations. The provision waives the 10 percent penalty tax for premature distributions from IRAs and qualified retirement plans for individuals who suffered an economic loss because of Rita or Wilma and whose principal residence is located in the Rita or Wilma disaster areas. Individuals eligible for this waiver would be permitted to pay income tax on such distributions ratably over a three-year period. Amounts distributed could be re-contributed to a qualified retirement plan over the three-year period following the distribution date and receive rollover treatment. The waiver of the 10 percent penalty, 3-year income averaging and recontribution provisions for retirement plan withdrawals will be limited to \$100,000 per individual. Distributions for home purchases which were not finalized because of Hurricanes Rita or Wilma could also be re-contributed to a qualified retirement plan or IRA. Limitations on loans from qualified employer plans would be increased for Hurricane Rita and Hurricane Wilma victims by doubling the thresholds to the lesser of \$100,000 or 100 percent of the individual's account balance. Payments due from hurricane victims on qualified plan loans on or after August 25, 2005, and before January 1, 2007, could be deferred, and twelve months could be added to the maximum repayment period of affected loans. The proposal is estimated to cost \$162 million over five years.
- **Employee Retention Credit.** Current law allows employers to deduct the cost of salaries paid to employees. This provision establishes a 40 percent tax credit for wages paid up to \$6,000 if paid following Hurricanes Rita and Wilma before December 31, 2005, by employers located in the disaster zones of Hurricane Rita or Wilma without regard to the size of the employer. The employee's usual and principal place of work must have been in the disaster zone, but the credit is not affected if the employee reports to work at another location. Wages paid to relatives would be ineligible for the credit. The proposal is estimated to cost \$24 million over five years.
- **Corporate Charitable Contributions.** The amount allowed as a charitable deduction for a corporation in any taxable year may not exceed 10 percent of the corporation's taxable income. The provision temporarily waives limits regarding charitable cash contributions for Rita and Wilma relief. The provision is effective for contributions before January 1, 2006. The proposal is estimated to cost \$78 million over five years.
- **Casualty Loss Provision.** Under present law, non-business casualty losses are deductible by taxpayers who itemize only to the extent they exceed 10 percent of adjusted gross income and a \$100 floor. In some circumstances, taxpayers are

permitted to include a current-year casualty loss on an amended prior year return. The provision eliminates the 10 percent and \$100 floor for casualty losses resulting from Hurricanes Rita or Wilma and incurred in the disaster area, including those claimed on amended returns. The proposal is estimated to cost \$1.174 billion over five years.

## **II. Expiring Tax Provisions**

**Small Business Expensing.** The 2003 tax act increased the amount that small businesses may expense from \$25,000 to \$100,000 for three years (through the end of 2005). The American Jobs Creation Act of 2004 (the “JOBS” Act) extended a slightly expanded version of small business expensing (with higher phase-out levels for small business) through 2007. The provision would extend that enhanced provision through the end of 2009. The proposal is estimated to cost \$7.3 billion over five years.

**Savers Credit.** The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 tax act) provided a temporary nonrefundable credit for contributions made by eligible taxpayers to certain qualified retirement plans (e.g., 401(k), 403(b), annuity, SIMPLE, SEP, traditional and Roth IRAs) through the end of 2006. The maximum annual contribution for the credit is \$2,000. The credit rate depends on the adjusted gross income of the taxpayer. Only taxpayers with AGI of \$25,000 or less (\$50,000 for married couples) are eligible for the credit. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The proposal would extend that provision through the end of 2009 and is estimated to cost \$4.1 billion over five years.

**Tuition Deduction.** The 2001 tax act created a new above-the-line tax deduction for qualified higher education expenses (defined in the same manner as the HOPE credit) paid during tax years 2002-2005. Currently, the maximum deduction is \$4,000 for taxpayers with AGI of \$65,000 or less (\$130,000 for married couples) or \$2,000 for taxpayers with AGI of \$80,000 or less (\$160,000 for married couples). The proposal would extend the provision through the end of 2009. The proposal is estimated to cost \$7.4 billion over five years.

**New Markets Tax Credit.** The proposal extends the new markets tax credit for one year (through the end of 2008), permitting a \$3.5 billion maximum annual amount of qualified equity investments. The proposal also requires that the Secretary prescribe regulations to ensure that non-metropolitan counties receive a proportional allocation of qualified entity investments. The estimated cost of the proposal is \$445 million over five years.

**State and Local Taxes.** The JOBS Act provided that for tax years 2004 and 2005, a taxpayer may elect to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes. Taxpayers were given two options for determining deductible sales tax: (i) actual sales tax paid if receipts are maintained for IRS verification or (ii) approximate sales tax paid as estimated

in tables provided by the Secretary of the Treasury. The proposal would extend the provision through the end of 2006, and is estimated to cost \$2.6 billion over five years.

**AMT Exemption Levels.** The 2003 tax act increased the AMT exemption amount to \$40,250 (\$58,000 married couples filing jointly) for 2003 and 2004 to prevent new taxpayers from becoming subject to the alternative minimum tax (AMT). The Working Families Tax Relief Act of 2004 extended those exemption amounts through the end of 2005. The proposal begins indexing the AMT for exemption levels for inflation and extends those increased exemption levels through the end of 2006 at an estimated cost of \$28.7 billion over five years.

**Nonrefundable Personal Credits Against Regular and Minimum Tax Liability.**

Certain nonrefundable personal credits (including dependent care, elderly and disabled, Hope Scholarship and Lifetime Learning, and the D.C. homebuyer) are allowed only to the extent that a taxpayer has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against AMT. Temporary provisions have been enacted which permit these credits to offset the entire regular and AMT liability through the end of 2005. The proposal would allow all of the nonrefundable personal tax credits, and the nonbusiness portion of the tax credits for alternative motor vehicles and alternative motor vehicle refueling property, to the full extent of the individual's regular tax and alternative minimum tax for taxable years beginning in 2006. The proposal is expected to cost \$2.9 billion over five years.

**Extension of the Research and Development Tax Credit.** The Tax Code provides a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The proposal would extend the present-law research credit (set to expire at the end of 2005) to qualified amounts paid or incurred during 2006, but would also enhance the credit by creating a new alternative that does not use gross sales as a factor in the regular credit so that newer businesses can access the credit. The proposal is estimated to cost \$9.2 billion over five years.

**Extension and Modification of the Work Opportunity Tax Credit (WOTC) and Welfare to Work (WTW).** Present-law provisions for WOTC and WTW are set to expire at the end of the year. The proposal would combine and extend those tax credits for one year. Key modifications of the combined credit would include expanded eligibility for WOTC (raised age ceiling for food stamp recipients from 25 to 40) and revised eligibility requirements for ex-felons (without regard to family income). The provision is estimated to cost \$690 million over five years.

**Qualified Zone Academy Bonds (QZABs).** QZABs are tax credit bonds issued by States or localities principally for school renovation. The bonds allow the lender to claim a tax credit against federal income taxes in lieu of receiving interest. The proposal extends the provision for one year and authorizes states to issue up to \$400 million of QZABs for 2006. Similar to recently enacted tax credit bond proposals, the proposal applies yield restriction and arbitrage rebate requirements in accordance with section 148.

It imposes a requirement that the issuer reasonably expect to and actually spend the proceeds on QZAB property within five years of the date of issue. Finally, the proposal requires the use of cash or cash equivalents to meet the current-law match requirement. The provision is estimated to cost \$55 million over five years.

**Enhanced Deduction for Corporate Contributions of Computer Equipment for Educational Purposes.** The proposal would extend a provision that encourages businesses to contribute computer equipment software to elementary, secondary, and post-secondary schools by allowing an enhanced deduction for such contributions. This proposal would extend the computer deduction provisions through the end of 2006 and is expected to cost \$121 million over five years.

**Deduction for Certain Expenses of Elementary and Secondary School Teachers.** In 2002, Congress began permitting teachers and other school professionals to deduct \$250 (above-the-line) for expenses paid or incurred for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services), other equipment, and supplementary materials used by the educator in the classroom. This provision expires at the end of 2005, and the proposal would extend the provision for an additional year. Estimated cost is \$199 million over five years.

**Brownfield Remediation Expensing.** The provision that permits expensing of costs associated with cleaning up hazardous (“brownfield”) sites expires on December 31, 2005. The proposal would extend current law through the end of 2006. In addition, it provides that petroleum products may be treated as hazardous substances and permits the expensing of payments made or incurred to abate contamination related thereto during 2006. The proposal is estimated to cost \$285 million over five years.

**Tax Incentives for Investment in the District of Columbia.** The proposal extends for an additional year four provisions intended to encourage redevelopment, capital investment, and homeownership in financially-distressed areas of D.C.: (1) designation of D.C. enterprise zone; employment tax credit; additional expensing; (2) tax-exempt D.C. empowerment zone bonds; (3) zero-percent capital gains rate for investment in D.C. property acquired by 12/31/03; for gains through 1/1/06; and (4) tax credit for first-time D.C. homebuyers. Estimated cost is \$95 million over five years.

**Indian Employment Tax Credit.** A business tax credit is available for the employer of qualified employees that work and live on or near an Indian reservation. The credit is for wages and health insurance costs paid to qualified employees (up to \$20,000) in the current year over the amount paid in 1993. Wages for which the work opportunity tax credit is available are not qualified wages for the Indian employment tax credit. The proposal would extend the provision an additional year through 2006 at an estimated cost of \$62 million over five years.

**Accelerated Depreciation for Business Property on Indian Reservations.** A special depreciation recovery period applies to qualified Indian reservation property placed in

service before January 1, 2005. In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. The proposal would extend the provision an additional year at a cost of \$445 million over five years.

**Leasehold Improvement Recovery.** In the JOBS Act, Congress shortened the cost recovery of certain leasehold improvements and restaurant property from 39 to 15 years for the remainder of 2004 and 2005. The proposal would extend that provision through the end of 2006 at an estimated cost of \$996 million over five years.

### **III. Provisions Affecting Charitable Tax Organizations**

#### **A. Incentives to Encourage Charitable Giving**

**Non-Itemizer/Itemizer Deduction.** The bill provides for a charitable deduction for cash donations made by taxpayers who do not itemize their deductions (approximately 74 percent of filers currently cannot take a charitable deduction because they do not itemize). The bill creates a floor of \$210 for single filers (\$420 for joint filers) that applies to both taxpayers who do not itemize and those that do. The new deduction is not subject to an income cap. In conjunction with expansion of charitable deductions, the bill provides improved anti-abuse rules for recordkeeping and substantiation of charitable donations for cash and non-cash items (e.g., clothing and household items). The estimated cost of the proposal is \$2 million over five years.

**Tax-Free Distributions From IRAs for Charitable Purposes.** The bill provides an exclusion from gross income for certain distributions from a traditional or a Roth IRA, which would otherwise be taxable. To qualify, the charitable distribution must be made either to (1) a tax-exempt organization to which deductible contributions can be made, or (2) a “split-interest entity,” such as a charitable remainder annuity trust or charitable remainder unitrust, a pooled income fund, or a charitable gift annuity. Special rules apply to IRAs that include non-deductible contributions to determine the portion of a distribution that is eligible to be a qualified charitable distribution. The estimated cost of the proposal is \$526 million over five years.

**Charitable Deduction for Contributions of Food Inventory.** For donations of food inventory by qualifying businesses, the bill provides an enhanced deduction equal to the lesser of the fair market value or twice the taxpayer’s basis in the contributed inventory. The enhanced deduction is available only for food that qualifies as “apparently wholesome food,” which is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions. The estimated cost of the proposal is \$369 million over five years.

**Basis Adjustment to Stock of S Corporation Contributing Property.** The bill provides that the amount of a shareholder's basis reduction in the stock of an S corporation, by reason of a charitable contribution made by the corporation, will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property. The estimated cost of the proposal is \$81 million over five years.

**Charitable Deduction for Contributions of Book Inventory.** The bill modifies the current-law deduction for contributions of qualified book inventory by C corporations, making the deduction equal to the lesser of the fair market value or twice the taxpayer's basis in the contributed property. The fair market value for this purpose is determined by reference to a bona fide published market price for the book. A qualified book contribution means a charitable contribution of books to: (1) an educational organization; (2) a public library; or (3) a tax-exempt organization with the primary purpose of making books available to the general public at no cost or to operate a literacy program. The estimated cost of the proposal is \$39 million over five years.

**The Tax Treatment of Certain Payments to Controlling Exempt Organizations.** Under current law, rent, royalty, annuity, and interest income received by a taxable or tax-exempt subsidiary that is controlled by a parent tax-exempt organization is generally treated as unrelated business income, which is taxable to tax-exempt parent organizations. The bill provides that this rule applies only to the portion of payments received or accrued in a taxable year that generally exceeds the fair market value of the specified payment. The proposal also extends the present-law public disclosure and inspection requirements and penalties applicable to Form 990 to the unrelated business income tax returns of charitable organizations. The estimated cost of the proposal is \$148 million over five years.

## **B. Reforms Applicable to Charitable Organizations**

**Involvement by exempt organizations in tax-shelter transactions.** The bill subjects certain tax-exempt entities to penalties for participating in a prohibited tax-shelter transaction as accommodation parties. A prohibited tax-shelter transaction is generally any transaction that the Treasury Secretary determines is a listed transaction or a reportable transaction as defined under current law. The bill also clarifies that an exempt organization that participates in a reportable transaction (including a listed transaction) in order to shelter from tax the organization's own tax liability (e.g., the unrelated business income tax) is subject to the current-law rules pertaining to disclosure of such transactions. The proposal is estimated to raise \$130 million over five years.

**Reform of Certain Life Insurance Contracts.** In general, the bill imposes an excise tax, equal to 100 percent of the acquisition costs, on the taxable acquisition of any interest in an applicable insurance contract. An applicable insurance contract is any life insurance, annuity, or endowment contract in which both an applicable tax-exempt organization and any person that is not a tax-exempt organization have, directly or indirectly, held an interest in the contract. The provision is subject to a de minimis rule

for certain interests held as part of a diversified strategy. The bill also provides regulatory authority for the Treasury Department to except certain contracts from treatment as applicable insurance contracts. The proposal is estimated to raise \$61 million over five years.

**Fines and Penalties Applicable to Charitable Organizations.** In general, the bill doubles the amount of excise taxes applicable to certain activities by private foundations and private foundation managers, and it increases the dollar limitations applicable to excise taxes on managers of public charities, private foundations, and social-welfare organizations. The proposal is estimated to raise \$18 million over five years.

**Charitable Contributions of Facade Easements.** Under the bill, a charitable deduction is allowable with respect to easements concerning buildings located in a registered historic district, but the qualified real-property interest that relates to the exterior of the building must preserve the entire exterior of the building, not merely its facade. In addition, the easement must provide that no portion of the exterior of the building may be changed or altered in a manner inconsistent with the historical character of such exterior. For certain large easement deductions, the bill also imposes a user fee and applies expanded reporting requirements and appraisal requirements. The proposal is estimated to raise \$25 million over five years.

**Taxidermy and Substantiation of Exempt Use Property.** For contributions of exempt-use taxidermy property with a claimed value of more than \$500 but not more than \$5,000, the taxpayer must supply the IRS with a photograph of the taxidermy and comparable sales data for similar items within the previous six months. For claims of more than \$5,000, the taxpayer must request a Statement of Value from the IRS (currently available for art and collectibles). The proposal is estimated to raise \$18 million over five years.

**Clothing and Household Items.** The proposal requires the Secretary to prepare and publish an itemized list of clothing and household items and assign an amount to each item on the list. Any deduction for a charitable contribution of such item may not exceed the item's assigned amount. If the item is not "in good condition" the donor would be limited to taking a deduction equal to twenty-percent of the list value. Contributions for which the taxpayer gets an appraisal are not subject to the proposal. For contributions of clothing or household items with a claimed value of more than \$500, the taxpayer may elect to use the amount received by the charity from sale of the item rather than the list value. The proposal is estimated to raise \$178 million over five years.

**Partial Interest in Donated Property.** The bill requires that charities receiving a fractional interest in an item of tangible personal property must take actual possession of the item for a period of time corresponding substantially to the charity's percentage interest in the item. The proposal is estimated to raise \$34 million over five years.

**Appraisal Reform.** The bill lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property, for which a

qualified appraisal is required (i.e., appraisals are required for donations of over \$5,000, under current law). The bill also provides definitions of a qualified appraiser and qualified appraisals. The proposal is estimated to raise \$5 million over five years.

**Credit Counseling.** The bill imposes certain restrictions on tax-exempt organizations that offer credit-counseling services. In order to stem abusive situations, the bill imposes restrictions on organizations offering credit-counseling services with respect to fees, solicitation of contributions from consumers receiving counseling, and the portion of the organization's total activities committed to credit counseling. The proposal is estimated to raise \$21 million over five years.

**Donor-Advised Funds.** The bill requires that sponsoring charities of donor-advised funds make a distribution equal to 5 percent of the aggregate asset balance of all donor-advised funds maintained by the sponsoring organization during the taxable year. The bill permits the use of set-asides (e.g., such as saving money for a building), and permits them to count toward the payout requirement. The bill includes anti-abuse provisions with respect to the new donor-advised-fund rules. The proposal is estimated to raise \$10 million over five years.

**Supporting Organizations.** The bill generally applies the current anti-abuse rules with respect to excess business holdings by private foundations to certain supporting organizations. Under the bill, supporting organizations must generally pay each taxable year to one or more public charities the sum of: (1) the greater of (i) 85 percent of its income or (ii) 5 percent of the aggregate fair market value of all of the assets of the organization (other than those used directly in supporting charitable programs), and (2) any repayments of amounts that were taken into account as support provided by the supporting organization in prior years. In addition, a new supporting organization may not support more than five organizations, and the supporting organization must notify in writing each organization designated for support. Anti-abuse provisions apply to supporting organizations that support an organization that the donor controls. The proposal is estimated to raise \$28 million over five years.

#### **IV. MISCELLANEOUS PROVISIONS**

**New York Liberty Zone Incentives for Transportation Infrastructure.** In 2002, a package of tax incentives were to assist in rebuilding of the New York Liberty Zone in the wake of 9-11. New York would like to restructure some of those incentives in order to obtain needed transportation infrastructure for the redevelopment of Lower Manhattan. The proposal would repeal several Liberty Zone incentives including special "bonus" depreciation, accelerated leasehold improvement recovery, increased section 179 expensing, and the extended replacement period for involuntary conversions. The proposal would provide a credit against tax imposed against New York State and City for the lesser of qualifying expenditures or the amount allocated to that governmental unit for the calendar year. The aggregate limit that may be allocated for all calendar years is \$2 billion and the estimated cost of the proposal is \$239 million over five years.

**S Corp Passive Investment Income.** S corporations are subject to corporate level tax at the highest rate if their passive investment income is excess of 25%. The proposal increases that percentage to 60% and repeals the termination of the S election rule for S corps with passive investment income for three consecutive taxable years. The proposal was estimated to cost \$511 million over five years.

**Industrial Development Bonds.** Qualified small issue bonds are tax-exempt state and local bonds used to finance private business manufacturing or the acquisition of land and equipment by certain farmers. The bonds are subject to limits on the amount of financing that may be provided. The proposal accelerates the application of the \$20 million capital expenditure limitation from bonds issued after September 30, 2009, to bonds issued after December 31, 2006. The proposal costs \$44 million over five years.

**Mortgage Insurance.** The proposal establishes an itemized deduction for the cost of mortgage insurance on a qualified personal residence. The deduction is phased-out ratably by 10% for each \$1,000 by which the taxpayer's AGI exceeds \$100,000. Thus, the deduction is unavailable for a taxpayer with an AGI in excess of \$110,000. The proposal is effective for amounts paid or accrued (and applicable to the period) after December 31, 2006 and before January 1, 2008 for mortgage contracts issued after December 31, 2006. The proposal is estimated to cost \$91 million over five years.

## **V. OFFSETS**

**Understatement of Taxpayer's Liability by Income Tax Return Preparer.** The provision raises the standard tax preparers must meet to avoid penalty. The proposal has a negligible revenue effect.

**Modification of Suspension of Interest and Penalties Where IRS Fails to Contact Taxpayer.** This provision is directed toward investors in abusive tax avoidance transactions that have been designated as "listed transactions" by the IRS. Generally, it eliminates the 18-month suspension of interest benefit that normally applies if the IRS does not notify the taxpayer of its tax liability within 18 months of the return due date. Generally, the provision is effective as if included in the JOBS Act. The proposal is estimated to raise \$396 million over five years.

**Frivolous Tax Submissions.** The provision increases the penalty for frivolous tax submissions from \$500 to \$5,000 and expands the penalty to all taxpayers and all types of federal taxes. This provision applies to submissions for collection due process, installment agreements, offers-in-compromise, and taxpayer assistance orders. This provision becomes effective for all submissions and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions. The proposal is estimated to raise \$15 million over five years.

**Clarification of the Economic Substance Doctrine and Penalty for Understatements Attributable to Transactions Lacking Economic Substance.** This provision clarifies

the application of the economic substance doctrine but does not change current-law standards used by courts in determining when to utilize an economic substance analysis. Under the provision, in any case in which a court determines that the economic substance doctrine is relevant to a transaction, the economic substance doctrine would be satisfied only if (1) the transaction changes in a meaningful way (apart from federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction, and the transaction is a reasonable means of accomplishing such purpose. The provision also imposes a 40 percent penalty on understatements attributable to a non-economic substance transaction (unless the transaction was disclosed, in which case the penalty is 20 percent). This provision becomes effective for transactions entered into after the date of enactment. The proposal raises \$5.2 billion over five years.

**Denial of Deduction for Interest on Underpayments Attributable to Non-Economic Substance Transactions.** This provision denies any deduction for interest on unpaid taxes attributable to any non-economic substance transaction understatement. This provision becomes effective for transactions entered into after the date of enactment. The proposal is estimated to raise \$9 million over five years.

**Waiver of User Fee for Installment Agreements Using Automated Withdrawals.** Current law imposes a \$43 user fee on taxpayers entering into an installment agreement. The provision waives the user fee if the taxpayer agrees to automated withdrawal of installment payments from a bank account. This provision would help facilitate collection through automated withdrawals. The proposal is estimated to cost \$14 million over five years.

**Termination of Installment Agreements.** This provision would terminate installment agreements for failure to file returns and failure to make deposits. Although a significant number of taxpayers violate the terms of their installment agreements by failing to timely file their tax returns or make required federal tax deposits, the IRS is not permitted to terminate installment agreements for these reasons. The provision would be effective for failures occurring after the date of enactment. Proposal has a negligible revenue effect.

**Offers-In-Compromise Partial Payments.** The provision requires that a taxpayer make a good faith down payment of 20 percent of any lump sum offer-in-compromise with any application for an offer. For periodic payment offers, the taxpayer is required to comply with their own payment schedule. The proposal also repeals the \$150 user fee and reduces the IRS time to accept an offer from 24 months to 12 months beginning in 2010. The proposal is estimated to raise \$683 million over five years.

**Increased Criminal Fines and Penalties.** The provision increases criminal fines and prison sentences for the three most common offenses: failure to file, filing a false or fraudulent return, and tax evasion. These proposed changes are substantially similar to increased criminal penalty provisions passed by the Senate in the JOBS Act. One notable change is the creation of a new aggravated failure to file offense. While retaining the current misdemeanor penalty for non-filers needed to address simple violations, the new

provision creates an aggravated offense to address more serious noncompliant behavior (“aggravated” means failing to file for three or more years with an aggravated tax liability of \$100,000 or more). The proposal is estimated to raise \$1 million over five years.

**Doubled Penalties for Concealment of Income Using Offshore Accounts.** The provision doubles penalties, interest, and fines on taxpayers deliberately concealing taxable income by using offshore accounts. This provision applies to taxpayers who have an offshore account and who have not signed a closing agreement in the IRS Offshore Voluntary Compliance Initiative (OVCI) or voluntarily disclosed participation in such arrangement to the IRS. This provision would become effective for taxpayers’ open tax years on or after the date of enactment. The proposal is estimated to raise \$5 million over five years.

**Denial of Deduction for Certain Fines, Penalties, and Other Amounts.** This provision clarifies that amounts paid or incurred whether by suit, agreement, or otherwise, to or at the direction of a government, in relation to a violation of any law or the governmental investigation or inquiry into the potential violation of law are not deductible for federal income tax purposes. The provision would be effective for amounts paid or incurred on or after the date of enactment unless paid under a binding order or agreement entered before that date. The proposal is estimated to raise \$157 million over five years.

**Deny Deduction for Punitive Damages.** This provision eliminates the deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person, and the insurer is required to report such amounts to both the insured person and to the IRS. The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment. The proposal is estimated to raise \$159 million over five years.

**Increase in Penalty for Bad Checks and Money Orders.** For bad checks of less than \$1,250, the penalty is raised to the lesser of \$25 or the amount of the check. This is an increase from the current threshold of less than \$750 and \$15. For amounts of \$1,250 or more, the penalty remains at 2 percent of the check amount. Proposal is estimated to raise \$10 million over five years.

**Inversions.** Congress enacted section 7874 as part of the JOBS Act to stop U.S. corporations and partnerships from engaging in inversion transactions to escape future U.S. tax on their foreign earnings and gain the ability to reduce U.S. tax on their U.S. operations. Section 7874 applies to two types of inversion transactions that occurred after March 4, 2003. In the first type of transaction, a U.S. corporation becomes a subsidiary of a foreign-incorporated entity and the former shareholders of the U.S. corporation own 80 percent or more of the foreign-incorporated entity. These foreign-incorporated entities are treated as U.S. corporations for all U.S. income tax purposes. In the second type of transaction, former shareholders of the U.S. corporation own 60

percent or more, but less than 80 percent, of the foreign-incorporated entity. In these transactions, the foreign-incorporated entity is treated as foreign, but any applicable corporate-level “toll-charge” taxes are not offset by tax attributes such as net operating losses or foreign tax credits. Section 7874 also applies inversion transactions involving certain partnerships. A transaction otherwise meeting the definition of an inversion transaction is not so treated if, on or before March 4, 2003, the foreign-incorporated entity had acquired more than half of the properties held by the domestic corporation, or partnership trade or business, as the case may be. This provision would make several changes to the inversion regimes of section 7874. First, section 7874 would apply to transactions completed after March 20, 2002 (as opposed to March 4, 2003 under present law). Second, the provision would lower the present-law 60 percent ownership threshold for the second category of inversion transactions to more than 50 percent, and would increase the accuracy-related penalties and tighten the earnings-stripping rules of section 163(j) with respect to companies involved in this type of transaction. Third, except as provided in regulations, the provision would exclude from the inversions regimes transactions involving non-publicly traded U.S. corporations. The proposal is estimated to raise \$937 million over five years.

**Impose Mark to Market on Individuals Who Expatriate.** This provision generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term residents who terminate their U.S. residency to tax on the net unrealized gain in their property as if such property were sold for fair market value. Gain from the deemed sale is taken into account at the time without regard to other Tax Code provisions. Any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Tax Code. Any net gain on the deemed sale is recognized to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). This provision becomes effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after the date of enactment. The proposal is estimated to raise \$286 million over five years.

**Modify the Tax Treatment of Contingent Payment Convertible Debt Instruments.** The provision creates a consistent “apples to apples” approach to value contingent convertible debt for purposes of computing original issue discount (OID). A “comparable rate” for a contingent convertible debt instrument would be based on a non-contingent, convertible debt instrument (and a non-convertible debt instrument, as the IRS now applies the law). The proposal is estimated to raise \$221 million over five years.

**Grant Treasury Regulatory Authority to Address Foreign Tax Credit Transactions.** The provision authorizes the Secretary of the Treasury to promulgate regulations to address abusive foreign tax credit schemes that involve the inappropriate separation of foreign taxes from the related income. The provision becomes effective for transactions entered into after the date of enactment. The proposal is estimated to raise \$6 million over five years.

**Modification of Effective Dates of Leasing Provisions of the JOBS Act.** This provision repeals an exceedingly generous grandfather rule permitting a leasing tax shelter abuse in the transportation sector called SILOs. SILO schemes allowed corporations to claim tax deductions for bridges, pipelines, and subways that are paid for with taxpayer dollars. Congress passed the JOBS Act last fall and outlawed SILOS for leases entered into after March 12, 2004. However, an exception was provided for property located in the United States subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2006, and (3) includes a description and fair market value of such property. The proposal would eliminate this exception. The proposal is estimated to raise \$108 million over five years.

**Application of Earnings-Stripping Rules to C Corporations Which are Partners.** Present law provides rules to limit the ability of U.S. subsidiaries of foreign corporations to reduce U.S. tax on their U.S. source income through earnings-stripping transactions. The present-law earning-stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of partnership liabilities is treated as debt of the corporation for purposes of applying the earnings-stripping limitation to the corporation's own interest payments. The proposal applies a rule attributing partnership debt to the corporate partners for this earnings-stripping test. The proposal is estimated to raise \$121 million over five years.

**Limit Employer Deduction for Certain Entertainment Expenses.** The employer expense deduction for goods, services, and facilities provided to an employee is limited to the amount treated as compensation on the employer's tax return and as wages on the employee's tax return. In the case in which the recipient is not an employee, the deduction is also limited to the amount of the expenses includible in the gross income of the recipient. The proposal raises \$20 million over five years.

**Increase Age Limit Under Section 1(g).** Increases the age of minors to which the kiddie tax provisions apply from 14 to 18. The proposal provides an exception for distributions for certain disability trusts and raises \$776 million over five years.

**Impose Loan and Redemption Requirements on Pooled Financing Bonds.** The proposal imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the proposal imposes a written loan requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified. Second, the issuer must reasonably expect that at least 50 percent of the net proceeds of the pooled bond will be lent to borrowers one year after the date of issue. Third, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the proposal eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of determining whether the issuer qualified for the small issuer exception rebate. The loan commitment requirement does not apply to bonds issued by States (or an integral part of a State) to provide loans to subordinate governmental units or State entities created to

provide financing for water-infrastructure projects through the EPA-sponsored State Revolving Fund Program. The proposal raises \$197 million over five years.

**Amend Information Reporting Requirements to Include Interest on Tax-exempt Bonds.** There are a number of reasons why the amount of tax-exempt interest received is relevant to determining tax liability despite the general exclusion from income. Under the proposal, interest paid on tax-exempt bonds is subject to information reporting in the same manner as interest paid on taxable obligations. The proposal raises \$9 million over five years.

**Modification of the Non-Conventional Fuels Credit.** The bill modifies the manner in which the phase-out of the non-conventional fuel credit is calculated by using the applicable fuel price in the prior taxable year, rather than the current year, as under current law. In addition, the bill generally repeals the phase-out limitation entirely for coke and coke gas, and it eliminates the inflation adjustment for all fuels other than coke and coke gas for 2005, 2006, and 2007. The proposal raises \$151 million over five years.

**Individual Estimated Tax Safeharbor.** An individual generally not subject to penalties if the taxpayer makes timely estimated tax payments equal to the lesser of: (i) 90% of the tax shown on the current year return or (ii) 100% of the prior year's tax. For taxpayers with a prior year's AGI above \$150,000, however, the rule that allows payment of 100% of prior year's tax is modified to 110%. The proposal would increase that amount to 119% of prior year's tax for estimated payments made for taxable year 2006. The percentage will revert to 110% for taxable years 2007 and thereafter. The proposal raises \$4.8 billion in 2006 and loses \$4.8 billion in 2007.

**Revaluation of LIFO Inventories of Large Integrated Oil Companies.** Under current law, businesses are generally permitted to use a last-in, first-out (LIFO) method to account for their inventories, provided they use the same accounting method for other reporting purposes. When prices are rising (as with oil prices in recent months), the LIFO method generally reduces the business' income and its tax liability. The proposal disallows, in effect, 75 percent of the LIFO-method benefit for integrated oil companies with gross receipts in excess of \$1 billion. The proposal is effective for the most recent taxable year of relevant taxpayers ending in 2005. The proposal is estimated to raise \$4.9 billion over five years.

**Elimination of Amortization of Geological and Geophysical Expenditures for Major Integrated Oil & Gas Companies.** The proposal eliminates 2-year amortization treatment for certain expenditures made by fully integrated oil companies, as provided in the Energy Policy Act of 2005 and is effective as though it had not been provided in that legislation. The proposal is estimated to raise \$135 million over ten years.