

Committee on Ways and Means

H.R. 4297, *the Tax Increase Prevention and Reconciliation Act of 2005*

Highlights of Conference Report

- Capital Gains and Dividends – Two-year extension of reduced capital gains and dividend rates through 2010.
- AMT Relief – Extension of AMT relief for 2006, including increased exemption levels and favorable treatment of non-refundable personal tax credits.
- Enhanced Section 179 Expensing – Two-year extension of enhanced section 179 expensing through 2009.
- Subpart F Reform – Two-year extension of the active financing exception. In addition, the Conference Report establishes the “CFC look-through” rule for three years.
- Revenue Offset Provisions – Narrowly-targeted revenue offset provisions that address specific tax avoidance and compliance issues. The Conference Report does not contain controversial Senate “revenue raisers” that have drawn bipartisan concern, such as codification of the economic substance doctrine.

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Detailed Summary of Conference Report

Two-Year Extension of Reduced Rates on Capital Gains and Dividends

Under current law, capital gains and dividend income are taxed at a maximum rate of 15-percent rate through 2008. For taxpayers in the 10- and 15-percent tax brackets, the tax rate is 5 percent through 2007 and zero in 2008. The Conference Report extends the rates effective in 2008 through 2010. Without action, these rates would have increased after 2008.

Alternative Minimum Tax Relief

1. Increase in AMT Exemption Levels

The provision extends the Alternative Minimum Tax (AMT) exemption levels through the end of 2006 at a higher level than in 2005. The new exemption levels for 2006 are \$62,550 for joint filers and \$42,500 for single filers.

2. AMT Relief for Non-Refundable Personal Tax Credits

The tax code includes many non-refundable personal tax credits, such as the dependent care credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, the Hope credit for certain college expenses and the Lifetime Learning credit, among others. Claiming these credits may push an individual into the AMT. The provision extends current law which allows most non-refundable personal tax credits to be claimed against the AMT so that families continue to receive the full benefit of these tax credits.

Extension and Modification of Certain Provisions

1. Two-Year Extension of Enhanced Section 179 Expensing for Small Business

Under current law, small businesses may expense (i.e., deduct in the first year) up to \$100,000 of investments in depreciable assets. The deduction phases out dollar-for-dollar to the extent the business's annual investments exceed \$400,000. Without action, the expensing limit would have declined to \$25,000 and the phase-out threshold would have declined to \$200,000 after 2007.

2. Subpart F

Subpart F of the tax code imposes immediate taxation on foreign subsidiaries of U.S. companies, even if their income has not been brought back to the United States. One provision extends an existing exception from Subpart F for active financing income for two years. A second provision provides a "CFC look-through" rule exception from Subpart F for cross-border payments of dividends, interest, rents, and royalties that are funded with active income that has

not been repatriated. This “CFC look-through” rule will be effective for taxable years beginning after December 31, 2005 and before January 1, 2009.

Other Provisions

1. Tax Treatment of Environmental Cleanup Funds

Under current law, income earned by certain environmental cleanup funds is taxable to the company that contributed to the fund. This is the case even though the taxpayer has permanently surrendered all control and dominion over the money in the fund. The provision treats environmental cleanup settlement funds as governmentally owned (i.e., not subject to tax) if certain standards and requirements are met. Eliminating the tax surcharge will encourage more companies to establish settlement funds devoted to environmental cleanup.

2. Simplification of Active Trade or Business Test

The provision simplifies the application of the active trade or business test to certain corporate distributions. By applying this test on an affiliated group basis, the provision applies the same standard regardless of whether a business is owned by a holding company or owned directly. As a result, the provision allows corporations to avoid costly and inefficient internal restructurings prior to engaging in certain corporate distributions to their shareholders.

3. Enhancing Veterans’ Access to Affordable Mortgages

Certain States have qualified veterans’ mortgage bond programs that allow these States to finance affordable mortgages for veterans. Under current law, veterans are eligible for these mortgages only if they served prior to 1977 and apply for these mortgages within a 30-year eligibility period after they leave active service. The provision expands eligibility for the program in a number of these States by repealing the requirement that veterans must have served before 1977 and reducing the eligibility period from 30 years to 25 years.

4. Tax Treatment of Self-Created Musical Works

The provision provides capital gains treatment for self-created musical works when these works are sold by the artist. Under current law, such sales are taxed as ordinary income.

5. Modification of the Tonnage Tax

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

6. Tax Treatment of the Permanent University Fund

The provision codifies and extends the current IRS exception for a portion of the Permanent University Fund from the tax-exempt bond arbitrage rules. This codification preserves a statutory and regulatory exception that has been part of the law for more than 20 years. The Permanent University Fund is used to finance capacity-enhancing infrastructure at certain public universities.

7. Amortization for Songwriters

The provision allows taxpayers to elect to amortize the costs of creating or acquiring a musical composition over five years. This election would be made in lieu of the income forecast method for these advances.

8. Industrial Development Bonds

Qualified small issue bonds are tax-exempt State and local bonds used to finance private business manufacturing facilities 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 provision accelerates the application of the increased \$20 million capital expenditure limitation from bonds issued after September 30, 2009 to bonds issued after December 31, 2006.

9. Loans to Qualified Continuing Care Facilities

The provision reforms the tax treatment of loans to continuing care facilities.

Corporate Estimated Tax Provisions

The timing of certain corporate estimated tax installment payments has been changed. These changes are revenue-neutral over the 2006 to 2015 fiscal year budget period.

Revenue Offset Provisions

1. Application of Earnings Stripping Rules to C Corporations Which are Partners

The provision codifies proposed Treasury regulations attributing partnership interest income, interest expense and liabilities to corporate partners for purposes of applying the earning stripping rules.

2. Amend Information Reporting Requirements to Include Interest on Tax-Exempt Bonds

The provision provides that interest paid on tax-exempt bonds is subject to information reporting in the same manner as interest paid on taxable obligations.

3. Amortization of Geological and Geophysical Expenditures for Major Integrated Oil & Gas Companies

The provision replaces two-year amortization treatment for certain expenditures made by major integrated oil companies with five-year amortization treatment.

4. FIRPTA

The first provision modifies the scope of the application of the *Foreign Investment in Real Property Tax Act of 1980* (FIRPTA) regime by targeting those qualified investment entities with significant interests in United States real property and modifies the application of FIRPTA for investors that own not more than 5 percent of certain qualified investment entities. A second provision modifies the ability of a foreign investor to avoid the FIRPTA regime by investing in a tiered qualified investment entity. Finally, a third provision imposes a FIRPTA obligation on foreign investors that engage in sale and repurchase transactions in order to avoid capital gain distributions that would otherwise subject the foreign investor to FIRPTA withholding.

5. Limitation on Certain Corporate “Cash Rich” Spin-Off Transactions

The provision denies tax-free treatment to certain spin-offs where either the distributing corporation or the controlled corporation is a “disqualified investment corporation,” defined as having investment assets that are two-thirds or more (75 percent or more under a first-year transition rule) of the value of the corporation’s total assets.

6. Impose Loan and Redemption Requirements on Pooled Financing Bonds

The provision imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the issuer must reasonably expect that at least 30 percent of the net proceeds of the pooled bonds will be lent to borrowers one year after the date of issue. Second, the provision imposes a 30 percent written loan requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified. Third, the provision requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the provision eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of determining whether the issuer qualified for the small issuer exception rebate. The written 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.

7. 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 while the offer is being considered. The provision also provides that an offer is deemed accepted if the IRS does not make a decision with respect to the offer within two years from the date that the offer was submitted.

8. Taxation of Passive Income of Minors

Under current law, minors under age 14 are taxed on their unearned income (i.e., passive income such as interest) at their parent's marginal tax rate. The provision increases the age of minors subject to this tax to those minors under age 18. The provision also provides an exception for distributions from certain qualified disability trusts.

9. Withholding on Certain Payments Made By Governmental Entities

The provision requires three-percent withholding on payments (including payments made in connection with a government voucher or certificate program, such as payments made under certain Department of Agriculture programs) for property and services made by the Federal government and by all State and local governments (other than local governments with less than \$100 million of annual expenditures) and their instrumentalities. The provision excludes a number of payment types from withholding, including payments related to certain public benefits programs. The provision applies to payments made after December 31, 2010.

10. Conversion to Roth IRAs

The provision allows more taxpayers to convert to Roth IRAs by removing the modified adjusted gross income limitations on rollovers from an IRA to a Roth IRA. Under the provision, taxpayers can elect to pay tax on amounts converted in 2010 in equal installments in 2011 and 2012.

11. Repeal FSC/ETI Grandfather Rules For Certain Binding Contracts

In compliance with a recent ruling of the World Trade Organization, the provision repeals the rules grandfathering certain binding contracts under the foreign sales corporation/extraterritorial income (FSC/ETI) regimes.

12. Domestic Manufacturing Deduction Wage Limitation

The domestic manufacturing deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year. The provision clarifies that only those wages allocable to domestic production gross receipts are included for purposes of this limitation.

13. Foreign Earned Income and Employer-Provided Housing Exclusion Rules for U.S. Citizens Living Abroad

U.S. citizens living and working abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign employer-provided housing costs. The provision reforms the rules applicable to these citizens by (i) accelerating indexing of the \$80,000 foreign earned income exclusion cap, (ii) tying the employer-provided housing exclusion to the foreign earned exclusion cap and applying an objective standard in determining the amount of reasonable housing expenses, and (iii) applying a "stacking rule" to ensure that these citizens are subject to the same U.S. tax rates as individuals living and working in the U.S.

14. Involvement of Accommodation Parties in Tax Shelter Transactions

The provision subjects certain exempt entities to penalties for participating in prohibited tax shelter transactions as accommodation parties. A prohibited tax shelter transaction is generally any transaction that the Secretary of the Treasury determines is a listed transaction or a reportable transaction as defined under current law.