Senate Finance Committee

Summary of the *Tax Increase Prevention and Reconciliation Act of 2005*

Extension and Modification of Certain Provisions

1. Increased Expensing for Small Business [Both House and Senate Bill Provisions]

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 expected to cost $7.274 billion over 5 years and $271 million over 10 years.

2. Reduced Rates on Capital Gains and Dividends [House Bill Provision]

Under current law, capital gains and dividend income are taxed at a 15-percent rate. The rate will be reduced to zero in 2008 for taxpayers in the 10- and 15-percent tax brackets. Without action, these rates will increase after 2008. The provision extends these reduced rates through 2010. These proposals are expected to cost $20.551 billion over 5 years and $50.783 billion over 10 years.

3. Controlled Foreign Corporations [House Bill Provisions]

Exception under subpart F for active financing and insurance income. Subpart F of the tax code imposes immediate taxation on the income earned by foreign subsidiaries of U.S. companies, even if their income has not been brought back to the United States. There is a temporary exception from Subpart F for active financing and insurance income. The active financing exception generally applies to the U.S.-based financial services and insurance industries and to domestic manufacturers who finance sales of large equipment to foreign customers. The conference agreement extends the active financing exception for two years, until the end of 2008. The proposal is expected to cost $4.796 billion over 5 years and 10 years.

Look-through treatment of payments between related CFCs under foreign personal holding company income rules. The conference agreement adds a new temporary exception from subpart F for dividends, interest, rents and royalties received by one CFC from a related CFC to the extent attributable to non-subpart F income of the payor. Effective for tax years beginning after 12/31/05 and before 1/1/09. The proposal is expected to cost $746 million over 5 years and 10 years.

Other Provisions

1. **Taxation of Certain Settlement Funds [House Bill Provision]**

The provision provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any State of political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

The provision does not apply to accounts or funds established after December 31, 2010. The proposal is expected to cost $44 million over 5 years and $116 million over 10 years.

2. **Modify Rules for Distributions of Controlled Corporations [House and Senate Provisions]**

The proposal simplifies the active business test for tax-free corporate spin-offs by looking at all corporations in the distributing corporation's and the spun-off subsidiary's respective affiliated group to determine if the active business test is satisfied. The proposal is expected to cost $33 million over 5 years and $51 million over 10 years.

3. **Expand the Qualified Veterans' Mortgage Bond Program [House Bill Provision With Modification]**

In the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, (1) the requirement that veterans must have served before 1977 is repealed and (2) the eligibility period for applying for a loan following release from the military service is reduced from 30 years to 25 years. In addition, the annual issuance of qualified veterans' mortgage bonds in the States of Alaska, Oregon and Wisconsin is subject to new State volume limitations which are phased in between the years 2006 and 2010. The State volume limit in these States for any calendar year after 2010 is zero. The provision expanding the definition of eligible veterans applies to financing provided after date of enactment. The provision amending State volume limitations applies to allocations of volume limitation made after April 5, 2006. The conference agreement does not amend present law as it relates to qualified veterans' mortgage bonds issued by the States of California and Texas. The proposal is expected to cost $7 million over 5 years and $32 million over 10 years.

4. **Capital Gains Treatment for Certain Self-Created Musical Works [House Bill Provision]**

The conference agreement provides that at the election of a taxpayer, the sale or exchange of musical compositions or copyrights in musical works created by the taxpayer's personal efforts is treated as the sale or exchange of a capital asset. The provision is effective for sales or exchanges before January 1, 2011, in taxable years beginning after the date of enactment. The proposal is expected to cost $14 million over 5 years and $20 million over 10 years.

5. **Vessel Tonnage Limit [House Bill Provision]**

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. The proposal is expected to cost $17 million over 5 years and $20 million over 10 years.

6. **Modification of Bond Rule for Certain Funds [House Bill Provision]**

The proposal extends the grandfather exception from the arbitrage bond rules for permanent university funds. The limitation on the aggregate amount of bonds which may benefit from the exception remains at 20 percent for the value of the Fund. The provision is effective for bonds issued after the date of enactment and before August 31, 2009. The proposal is expected to cost $4 million over 5 years and $5 million over 10 years.

7. **Amortization of Song Rights [Senate Provision With Modification]**

The proposal allows music publishers to elect to amortize over five years the advances they make to songwriters. This five-year amortization method would be an alternative to the income forecast method of accounting for these advances. The proposal is expected to raise $6 million over 5 years and cost $13 million over 10 years.

8. **Industrial Development Bonds [Senate Provision]**

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 is expected to cost $44 million over 5 years and $136 million over 10 years.

9. **Modification of Treatment of Loans to Qualified Continuing Care Facilities [Senate Provision With Modification]**

The conference agreement provision provides that a continuing care contract is a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for their life or lives; (2) the individual or the individual's spouse will be provided with housing, as appropriate for the health of such individual or individual's spouse, (i) in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), and (ii) in an assisted living facility or a nursing facility, as is available in the continuing care facility; and (3) the individual or the individual's spouse will be provided assisted living or nursing care as the health of the individual or the individual's spouse requires, and as is available in the continuing care facility. The Secretary is required to issue guidance that limits the term "continuing care contract" to contracts that provide only facilities, care, and services described in the preceding sentence.

For purposes of defining the terms "continuing care contract" and "qualified continuing care facility" under the conference agreement provision, the term "assisted living facility" is intended to mean a facility at which assistance is provided (1) with activities of daily living (such as eating, toileting, transferring, bathing, dressing, and continence) or (2) in cases of cognitive impairment, to protect the health or safety of an individual. The term "nursing facility" is intended to mean a facility that offers care requiring the utilization of licensed nursing staff. Effective date.–The conference agreement provision is generally effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date. The conference agreement provision does not apply to any calendar year after 2010. Thus, the conference agreement provision does not apply with respect to interest imputed after December 31, 2010. After such date, the law as in effect prior to enactment applies. The proposal is expected to cost $10 million over 5 years and 10 years.

<u>Individual AMT Provisions</u>

1. **Increase Individual AMT Exemption Amount [Senate Provision]**

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 provision would again extend the exemption levels though the end of 2006 but at a higher level -- $62,550 (married) and $42,500 (other). The proposal is expected to cost $31.047 billion over 5 years and 10 years.

2. **AMT Relief for Personal Tax Credits [Senate Provision With Modification]**

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 the nonrefundable personal tax credits 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 $2.825 billion over 5 years and 10 years.

Corporate Estimated Tax Provisions

1. Increase Corporate Estimated Tax Payments Due July through September for Certain Corporations [Conference Provision]

In case of a corporation with assets of at least $1 billion:

- Payments due in July, August, and September, 2006, shall be increased to 105 percent of the payment otherwise due, and the next required payment shall be reduced accordingly.
- Payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due, and the next required payment shall be reduced accordingly.
- Payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due, and the next required payment shall be reduced accordingly.

The proposal has a negligible revenue effect over 5 and 10 years.

2. Delay Due Date Until October 1 for a Percentage of Corporate Estimated Taxes That Are Otherwise Due On September 15 [Conference Provision]

With respect to corporate estimated tax payments due on:

- September 15, 2010, 20.5% shall not be due until October 1, 2010.
- September 15, 2011, 27.5% shall not be due until October 1, 2011.

The proposal is expected to cost $5.640 billion over 5 years and have a negligible effect over 10 years.

Revenue Offset Provisions

1. Application of Earnings Stripping Rules to Partners Which Are C Corporations [Senate Provision]

The conference agreement codifies proposed regulations by providing that, in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation's share of partnership liabilities, interest income, and interest expense are treated as liabilities, interest income, and interest expense of the corporation for purposes of applying the earnings stripping rules to the corporation. The provision is effective for taxable years beginning on or after the date of enactment. The proposal is expected to raise $106 million over 5 years and $284 million over 10 years.

2. **Reporting of Interest on Tax-Exempt Bonds [Senate Provision]**

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 a manner similar to interest paid on taxable obligations. The provision is effective for interest paid on tax-exempt bonds after December 31, 2005. The proposal is expected to raise $9 million over 5 years and $24 million over 10 years.

3. **5-Year Amortization of Geological and Geophysical (G&G) Costs for Major Integrated Oil Companies [Senate Provision With Modification]**

The conference agreement extends the two-year amortization period for G&G costs to five years for certain major integrated oil companies. Under the conference agreement, the five year amortization rule for G&G costs applies only to integrated oil companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, gross receipts in excess of $1 billion in the last taxable year ending during calendar year 2005, and an ownership interest in a crude oil refiner of 15 percent or more. The provision applies to amounts paid or incurred after date of enactment. The proposal is expected to raise $160 million over 5 years and $189 million over 10 years.

4. **Treatment of Distributions Attributable to FIRPTA Gains [Senate Provision With Modification]**

The conference agreement modifies the scope of the application of FIRPTA 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. The provision also restricts the ability of a foreign investor to avoid the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") regime by investing in a tiered qualified investment entity. Finally, the provision also 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. The proposal is expected to raise $13 million over 5 years and $28 million over 10 years.

5. **Modify Rules for Distributions of Controlled Corporations [Senate Provision With Modification]**

The conference agreement 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 of the value of the corporation's total assets. However, for distributions occurring within one year after the date of enactment, the investment asset threshold is three-fourths. The proposal is expected to raise $46 million over 5 years and $116 million over 10 years.

6. **Loan and Redemption Requirements on Pooled Financings [Senate Provision With Modification]**

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. The conference agreement requires issuers of pooled financing bonds to obtain, prior to issuance, written commitments from borrowers equal to at least 30 percent of the net proceeds of the pooled financing bond. Second, the issuer must reasonably expect that at least 30 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 is expected to raise $172 million over 5 years and $417 million over 10 years.

7. **Require Partial Payments With Submissions of Offers-In-Compromise [Senate Provision]**

The provision requires a taxpayer to make partial payments to the IRS while the taxpayer's offer is being considered by the IRS. For lump-sum offers, taxpayers must make a down payment of 20% of the amount of the offer with any application. For purposes of this provision, a lump-sum offer includes single payments as well as payments made in five or fewer installments. For periodic payment offers, the provision requires the taxpayer to comply with the taxpayer's own proposed payment schedule while the offer is being considered. Offers submitted to the IRS that do not comport with these payment requirements are returned to the taxpayer as unprocessable and immediate enforcement action is permitted. The provision eliminates the user fee requirement for offers submitted with the appropriate partial payment. The provision also provides that an offer is deemed accepted if the IRS does not make a decision with respect to the offer within two years from the date the offer was submitted. The provision authorizes the Secretary to issue regulations providing exceptions to the partial payment requirements in the case of offers from certain low-income taxpayers and offers based on doubt as to liability. The provision is effective for offers-in-compromise submitted on and after the date which is 60 days after the date of enactment. The proposal is expected to raise $699 million over 5 years and $1.911 billion over 10 years.

8. **Increase Age of Minor Children Whose Unearned Income is Taxed As if Parent's Income [Senate Provision With Modification]**

The provision increases the age to which the minor child tax provisions apply from under 14 to under 18 years of age. The conference agreement provides that the minor child tax does not apply to a child who is married and files a joint return for the taxable year. The provision also creates an exception to the minor child tax for distributions from certain qualified disability trusts, defined by cross-reference to sections 1917 and 1614(a)(3) of the Social Security Act. This tightens a loophole used to shelter investment income. The provision applies to taxable years beginning after December 31, 2005. The proposal is expected to raise $776 million over 5 years and $2.128 billion over 10 years.

9. **Withholding on Government Payments [Conference Provision]**

The National Taxpayer Advocate has concluded that the absence of a withholding mechanism on certain nonwage payments creates several problems, including contributing to the substantial tax gap and "harming compliant taxpayers because they pay their correct liability while others do not." The proposal balances the goal of greater compliance with concerns regarding administrative burdens of imposing withholding. The conference agreement requires withholding on certain payments to any person providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). Political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for goods or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement. The rate of withholding is 3% on all payments (including all payments made in connection with a government voucher or certificate program) regardless of whether the payments are for property or services. The provision imposes information reporting requirements on the payments that are subject to withholding under the provision. The provision does not apply to any payments made through a Federal, State, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. For example, payments under government programs providing food vouchers or medical assistance to low-income individuals are not subject to withholding under the provision. In addition, the provision does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. The proposal does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, withholding under the proposal does not apply. The proposal also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)); and payments to government employees that are not otherwise excludable from the new withholding provision with respect to the employees' services as an employees. The proposal applies to payments made after December 31, 2010, so the proposal has a negligible revenue effect over 5 years but is expected to raise $6.977 billion over 10 years.

10. **Eliminate the Income Limitations on Roth IRA Conversions [Conference Provision]**

The conference agreement eliminates the income limits on conversions of traditional IRAs to Roth IRAs. Thus, taxpayers may make such conversions without regard to their AGI.
For conversions occurring in 2010, unless a taxpayer elects otherwise, the amount includible in gross income as a result of the conversion is included ratably in 2011 and 2012. However, income inclusion is accelerated if converted amounts are distributed before 2012. In that case, the amount included in income in the year of the distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income. The provision is effective for taxable years beginning after December 31, 2009. The proposal is expected to cost $447 million over 5 years and to raise $6.432 billion over 10 years.

11. Repeal of FSC/ETI Binding Contract Relief (Grandfathered Contracts) [Conference Provision]

The conference agreement repeals both the FSC binding contract relief and the ETI binding contract relief. The general transition rule remains in effect. The provision is effective for taxable years beginning after date of enactment. The provision is intended to comply with the recent WTO Appellate Body ruling that the binding contract relief provision is a prohibited export subsidy. The proposal is expected to raise $467 million over 5 years and $502 million over 10 years.

12. Modify Wage Limitation for Section 199 [Conference Provision]

Under present law, the manufacturing deduction is limited to 50 percent of a taxpayer's W-2 wages. Under the conference agreement, the wage limitation is modified such that taxpayers may only include amounts which are properly allocable to domestic production gross receipts. In addition, as a simplification measure, the conference agreement repeals the special limitation on wages treated as allocated to partners or shareholders of passthrough entities. The proposal is expected to raise $43 million over 5 years and $181 million over 10 years.

13. Amend Section 911 Housing Exclusion and Impose a Stacking Rule and Provide Regulatory Authority to Allow for Geographic Differences [Conference Provision]

The conference agreement makes three changes to the foreign earned income exclusion and housing allowance. First, the income exclusion is indexed for inflation starting in 2006 (rather than 2008 under current law). Second, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16% of the amount of the foreign earned income exclusion limitation (instead of the present law 16% of the grade GS-14, step 1 amount). Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income, but the amount of the exclusion is limited to 30 percent of the taxpayer's foreign earned income exclusion. The Secretary is given authority to issue regulations or other guidance providing for the adjustment of this 30% housing cost limitation based on geographic differences in housing costs relative to housing costs in the United States. Third, income excluded as either foreign earned income or as a housing allowance is included for purposes of

determining the marginal tax rates applicable to non-excluded income. The provisions are intended to provide an objective standard to determine the amount that taxpayers working abroad can exclude from income and also to subject such individuals to the same tax rates applicable to individuals living and working in the United States who have the same amount of economic income. The non-partisan Joint Committee on Taxation recommended these changes. The proposal is expected to raise $903 million over 5 years and $2.126 billion over 10 years.

14. Tax Involvement of Accommodating Parties in Tax Shelter Transactions [Senate Provision With Modification]

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 expected to raise $123 million over 5 years and $428 million over 10 years.