DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE PROVISIONS OF THE "AMERICAN INFRASTRUCTURE INVESTMENT AND IMPROVEMENT ACT"

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "American Infrastructure Investment and Improvement Act," which is to be marked up by the Senate Committee on Finance on September 20, 2007.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "American Infrastructure Investment and Improvement Act"* (JCX-83-07), September 20, 2007. This document can also be found on our website at www.house.gov/jct.

A. Provisions Modifying the Proposals in the Chairman's Mark

1. Modification to item I.C. of the Chairman's Mark relating to subjecting fuel consumed during wholly domestic segments of international flights to tax at the domestic commercial aviation rate

The Chairman's modification strikes this provision.

2. Modification to item I.D. of the Chairman's Mark relating to the use of international air facilities tax

The Chairman's modification increases the tax on the use of international air travel facilities from $16.50 to $16.65.

3. Modification to item II.E of the Chairman's Mark relating to clarification of eligibility for certain fuel credits for fuel with insufficient nexus to the United States

The Chairman's modification strikes this provision.

B. Additional Provisions

1. Transparency in passenger tax disclosures

Present Law

Transportation providers are subject to special penalties if they do not separately disclose the amount of the passenger taxes on tickets and in advertising. Failure to satisfy these disclosure requirements is a misdemeanor, upon conviction of which the guilty party is fined not more than $100 per violation.[2]

There is no prohibition against airlines including other charges in the required passenger taxes disclosure (e.g., fuel surcharges retained by the commercial airline). In practice, some but not all airlines include such other charges in the required passenger taxes disclosure.

Description of Proposal

The proposal prohibits all transportation providers from including amounts other than charges payable to a government entity in the required disclosure of passenger taxes on tickets and in advertising. Disclosure elsewhere on tickets and in advertising (e.g., as an amount paid for transportation) of charges not payable to a government entity is allowed.

Effective Date

The proposal is effective for tickets sold after December 31, 2007.

2. Modification of pension funding rules of certain eligible plans

Present Law

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Code.[3] The Pension Protection Act of 2006 provides for new minimum funding rules, which are generally effective for plan years beginning after December 31, 2007.

Under the new minimum funding rules, the minimum required contribution to a single-employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. The plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year.

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[2] Sec. 7275. Except where otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Sec. 412. Similar rules apply to single-employer defined benefit pension plans under ERISA.

In general, a plan has a funding shortfall if the plan's funding target for the year exceeds the value of the plan's assets (reduced, if applicable, by any prefunding balance and funding standard carryover balance). If the value of a plan's assets (reduced by any funding standard carryover balance and prefunding balance) is less than the plan's funding target for a plan year, so that the plan has a funding shortfall, the minimum required contribution is generally equal to the plan's target normal cost, increased by a shortfall amortization charge. Alternatively, if the value of a plan's assets (reduced by any funding standard carryover balance and prefunding balance) is equal to or exceeds the plan's funding target for a plan year, the minimum required contribution is equal to the plan's target normal cost, reduced by the amount by which the plan's assets exceed the funding target.

The shortfall amortization charge for a plan year is the aggregate total of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for that plan year and the six preceding plan years. A shortfall amortization base is generally required to be established for a plan year if the plan has a funding shortfall for a plan year. The shortfall amortization base for a plan year is (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments (and, if applicable, waiver amortization installments) that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases (and waiver amortization bases) for preceding plan years. The shortfall amortization installments with respect to a shortfall amortization base for a plan year are the amounts necessary to amortize the shortfall amortization base in level annual installments over the seven-plan-year period beginning with the plan year. The shortfall amortization installment with respect to a shortfall amortization base for any plan year in the seven-year period is the annual installment determined for that year for that shortfall amortization base. Shortfall amortization installments are determined using the appropriate segment interest rates.

The new minimum funding rules specify the interest rates and other actuarial assumptions that must be used in determining a plan's target normal cost and funding target. Under the rules, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. In general, the corporate bond yield curve used for this purpose is to be prescribed on a monthly basis by the Secretary of the Treasury and reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. A special transition rule applies for plan years beginning in 2008 and 2009 (other than for plans first effective after December 31, 2007).

In addition to the new minimum funding rules described above, the Pension Protection Act of 2006 also provided for special funding rules to apply for certain eligible plans. An eligible plan is a single-employer defined benefit pension plan sponsored by an employer that is a commercial passenger airline or the principal business of which is providing catering services to a commercial passenger airline.

The plan sponsor of an eligible plan may make one of two alternative elections. In the case of a plan that meets certain benefit accrual and benefit increase restrictions, an election allowing a 17-year amortization of the plan's unfunded liability is available. In lieu of this election, a plan sponsor may alternatively elect, for the first taxable year beginning in 2008, to amortize the shortfall amortization base for such taxable year over a period of 10 plan years (rather than seven plan years) beginning with such plan year. Under this alternative election, the benefit accrual and benefit increase restrictions do not apply. This 10-year amortization election must be made by December 31, 2007. Public Law 110-28 modified the 10-year amortization election. As modified, if a plan sponsor elects to amortize the shortfall amortization base over a period of 10 plan years, the plan is to use an interest rate of 8.25 percent for purposes of determining the funding target for each of the 10 plan years during such period (instead of the segment rates calculated on the basis of the corporate bond yield curve).

Description of Proposal

The proposal provides that, in the case of a plan sponsor that elects to amortize the shortfall amortization base over a period of 10 plan years, an election must be made for the plan to use the 8.25 percent interest rate instead of the segment rate for purposes of determining the plan's funding target. The election can be made no more than once and is revocable. If the election is in effect, the minimum required contribution is not less than the target normal cost (which is calculated using the segment rates). Such minimum contribution is required even if the plan's assets exceed the plan's funding target plus normal cost.

Effective Date

The proposal takes effect as if included in section 402 of the Pension Protection Act of 2006.

3. Denial of deduction for punitive damages

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[4] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[5] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of

[4] Sec. 162(a).

[5] Sec. 162(c).

any law.[6] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[7]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[8] However, this exclusion does not apply to punitive damages.[9]

Description of Proposal

The proposal denies any 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 the IRS.

Effective Date

The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment.

4. Conform Highway Trust Fund provisions in the Code to include Public Law No. 110-56

Present Law

Public Law No. 110-56 authorized additional funds for emergency repairs and reconstruction of the Interstate I-35 bridge, located in Minneapolis, Minnesota, that collapsed on August 1, 2007. That Act also amended section 1112 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users ("SAFETEA") to authorize the use of not more than $5 million of funds to reimburse the Minnesota State Department of Transportation for actual and necessary costs of maintenance and operation for providing temporary substitute highway traffic service following the collapse. While the Act amended SAFETEA, it did not make conforming amendments to the Code.

The purposes for which Highway Trust Fund funds are permitted to be expended are fixed as of the date of enactment of SAFETEA (August 10, 2005), the Code must be amended in order to accommodate new purposes. In addition, the Code contains a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in

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[6] Sec. 162(f).

[7] Sec. 162(g).

[8] Sec. 104(a).

[9] Sec. 104(a)(2).

section 9503.[10] This provision provides that, should such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed but the receipts will be retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that may provide for them unless either the legislation providing for the expenditure amends the expenditure authorization provisions of section 9503 or otherwise authorizes the expenditure as part of a revenue Act.

Description of Proposal

The proposal adds section 1112 of SAFETEA as amended by Pub. Law No. 110-56 to the list of legislation authorizing the expenditure of funds from the Highway Trust Fund.

Effective Date

The proposal is effective on the date of enactment.

5. Fuel technical corrections

Energy-related technical corrections

Except as otherwise provided, the amendments made by the technical corrections contained in the bill take effect as if included in the original legislation to which each amendment relates.

Amendments to the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users

Timing of claims for excess alternative fuel (not in a mixture) credit and liquid hydrocarbons from biomass (Act sec. 11113)

The Code makes the alternative fuel (not in a mixture) credit refundable. Section 6427(i)(3) permits claims to be filed on a weekly basis with respect to alcohol, biodiesel, and alternative fuel mixtures if certain requirements are met. This rule, however, does not reference the alternative fuel credit (for alternative fuel not in a mixture). The amendment clarifies that the same rules for filing claims with respect to fuel mixtures applies to the alternative fuel credit.

The Code provides that alternative fuel includes "liquid hydrocarbons derived from biomass." It was intended that liquid hydrocarbons from biomass include fuels made from biomass such as fish oil, which contains some oxygen in addition to hydrogen and carbon. The amendment provides that alternative fuel includes "liquid fuel from biomass" and clarifies that fuels described in sections 6426(b) or (c), or sections 40 or 40A (alcohol, biodiesel, and renewable diesel), do not qualify for the alternative fuel credit or alternative fuel mixture credit.

[10] Sec. 9503(b)(6).

Amendments to the Energy Policy Act of 2005

Clarify limitation on the credit of installing alternative fuel refueling property (Act sec. 1342)

The present-law credit for qualified alternative fuel vehicle refueling property for a taxable year is limited to $30,000 per property subject to depreciation, and $1,000 for other property (sec. 30C(b)). The provision clarifies that the $30,000 and $1,000 limitations apply to all alternative fuel vehicle refueling property placed in service by the taxpayer at a location. The provision is consistent with similar deduction limitations imposed under section 179A(b)(2)(A) (relating to the deduction for clean-fuel vehicles and certain refueling property).

In addition, Code section 30C(c)(1) provides that qualified alternative fuel vehicle refueling property has the meaning given to the term by section 179A(d). However, section 179A(d) defines a different term, qualified clean-fuel vehicle refueling property. The provision coordinates the reference to this definition.

Double taxation of rail and inland waterway fuel resulting from the use of dyed fuel on which the Leaking Underground Storage Tank Trust Fund tax has already been imposed; off-highway business use (Act sec. 1362)

Section 4081(a)(2)(B) imposes tax at the Leaking Underground Storage Tank Trust Fund financing tax rate of 0.1 cent per gallon on diesel fuel at the time it is removed from a terminal. Section 4082(a) provides that none of the generally applicable exemptions other than the exemption for export apply to this removal even if the fuel is dyed. When dyed fuel is used or sold for use in a diesel powered highway vehicle or train (sec. 4041), or such fuel is subject to the inland waterway tax (sec. 4042), the Code inadvertently imposes the Leaking Underground Storage Tank Trust Fund tax a second time. Section 6430 prohibits the refund of taxes imposed at the Leaking Underground Storage Tank Trust Fund financing rate, except in the case of fuel destined for export. The amendment eliminates the imposition of the 0.1 cent tax a second time if the Leaking Underground Storage Tank Trust Fund financing tax rate previously was imposed under section 4081. The amendment permits a refund in the amount of the Leaking Underground Storage Tank Trust Fund financing rate if such tax was imposed a second time under 4041 or 4042. The amendment also clarifies that off-highway business use is not exempt from the Leaking Underground Storage Tank Trust Fund Financing rate, effective for fuel sold for use or used after the date of enactment.

Exemption from the Leaking Underground Storage Tank Trust Fund financing rate for aircraft and vessels engaged in foreign trade (Act. sec. 1362)

Fuel supplied in the United States for use in aircraft engaged in foreign trade is exempt from U.S. customs duties and internal revenue taxes, so long as, where the aircraft is registered in a foreign State, the State of registry provides substantially reciprocal privileges for U.S.-registered aircraft. However, the Energy Policy Act of 2005 imposed, without exemption, the Leaking Underground Storage Tank Trust Fund financing rate on all taxable fuels, except in the case of export. As a result, aviation fuel is no longer exempt from the Leaking Underground Storage Tank Trust Fund financing rate. According to the State Department, almost all of the

United States' bilateral air services agreements contain provisions exempting from taxation all fuel supplied in the territory of one party for use in the aircraft of the other party. The United States has interpreted these provisions to prohibit the taxation, in any form, of aviation fuel supplied in the United States to the aircraft of airlines of the foreign countries that are parties to these air services agreements. The amendment provides that fuel for use in vessels (including civil aircraft) employed in foreign trade or trade between the United States and any of its possessions is exempt from the Leaking Underground Storage Tank Trust Fund financing rate.

Amendment to the American Jobs Creation Act of 2004

Interaction of rules relating to credit for low sulfur diesel fuel (Act. sec. 339)

Section 45H of the Code allows a credit at the rate of five cents per gallon for low sulfur diesel fuel produced at certain small business refineries. The aggregate credit with respect to any refinery is limited to 25 percent of the costs of the type deductible under section 179B of the Code. Section 179B allows a deduction for 75 percent of certain costs paid or incurred with respect to these refineries. The basis of the property is reduced by the amount of any credit determined with respect to any expenditure (sec. 45H(d)). Further, no deduction is allowed for the expenses otherwise allowable as a deduction in an amount equal to the amount of the credit under section 45H (sec. 280C(d)). The interaction of these provisions is unclear, and the basis reduction and deduction denial rules may have an unintentionally duplicative effect. Under the provision, deductions are denied in an amount equal to the amount of the credit under section 45H, and the provisions of present law reducing basis and denying a deduction are repealed.

6. Motor Fuel Tax Enforcement Advisory Commission

Present Law

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users established a Motor Fuel Tax Enforcement Advisory Commission. The purpose of the Commission is to: (1) review motor fuel revenue collections, historical and current; (2) review the progress of investigations; (3) develop and review legislative proposals with respect to motor fuel taxes; (4) monitor the progress of administrative regulation projects relating to fuel taxes; (5) review the results Federal and State agency cooperative efforts regarding motor fuel taxes; and (6) review the results of Federal interagency cooperative efforts regarding motor fuel taxes. The Commission also is to evaluate and make recommendations regarding: (1) the effectiveness of existing Federal enforcement programs regarding motor fuel taxes; (2) enforcement personnel allocation; and (3) proposals for regulatory projects, legislation, and funding.

The Commission is to be composed of the following:

- At least one representative from each of the following Federal entities: the Department of Homeland Security, the Department of Transportation - Office of Inspector General, the Federal Highway Administration, the Department of Defense, and the Department of Justice;
- At least one representative from the Federation of State Tax Administrators;

- At least one representative from any State Department of Transportation;
- Two representatives from the highway construction industry;
- Six representatives from industries relating to fuel distribution: refiners (two representatives), distributors (one representative), pipelines (one representative), terminal operators (two representatives);
- One representative from the retail fuel industry; and
- Two representatives each from the staff of the Senate Committee on Finance and the House Committee on Ways and Means.

Members of the Commission are to be appointed by the Chairmen and Ranking Members of the Senate Committee on Finance and the House Committee on Ways and Means. Representatives from the Department of Treasury and the IRS shall be available to consult with the Commission upon request. The Commission is to terminate after October 1, 2009.

Description of Proposal

The proposal limits the Commission to 14 members. Under the proposal, the Commission is composed of :

- One member from the Department of Transportation;
- One member from the Department of Transportation – Federal Highway Administration;
- One member from the Department of Transportation – Inspector General;
- One member from the Department of Homeland Security;
- One member from the Department of Defense;
- One member from the Department of Justice;
- Two members shall be appointed by the Chairman of the Senate Committee on Finance;
- Two members shall be appointed by the Ranking Member of the Senate Committee of Finance;
- Two members shall be appointed by the Chairman of the House Committee on Ways and Means;
- Two members shall be appointed by the Ranking Member of the House Committee on Ways and Means.

The appointed members are to include at least one representative from the Federation of State Tax Administrators, at least one representative from a State department of transportation, at least one representative from industries relating to fuel distribution (refiners, distributors, pipelines and terminal operators), and at least one representative from the retail fuel industry. Not later than September 30, 2009, the Commission is to submit to Congress a final report that contains a detailed statement of the findings and conclusions of the Commission; and the recommendations of the Commission for such legislation and administrative action as the Commission considers appropriate and necessary. The proposal also makes other administrative changes.

Effective Date

The proposal is effective on the date of enactment.

7. Exemption of certain commercial cargo from the Harbor Maintenance tax

Present Law

The Code contains provisions imposing a 0.125-percent excise tax on the value of most commercial cargo loaded or unloaded at U.S. ports (other than ports included in the Inland Waterway Trust Fund system). The tax also applies to amounts paid for passenger transportation using these U.S. ports. Exemptions are provided for (1) exported commercial cargo, (2) cargo shipped between the U.S. mainland and Alaska (except for crude oil), Hawaii, and/or U.S. possessions, and (3) cargo shipped between Alaska, Hawaii, and/or U.S. possessions. Receipts from this tax are deposited in the Harbor Maintenance Trust Fund.

Description of Proposal

The proposal exempts from the Harbor Maintenance tax commercial cargo, other than bulk cargo, loaded at a U.S. or Canadian port located in the Great Lakes Saint Lawrence Seaway System and unloaded at another U.S. port located in such system.

For purposes of the proposal, the term "bulk cargo" has the meaning given such term by 46 U.S.C. sec. 53101(1), as in effect on the date of the enactment.[11]

For purposes of the proposal, the term "Great Lakes Saint Lawrence Seaway System" means the waterway between Duluth, Minnesota and Sept. Iles, Quebec, encompassing the five Great Lakes, their connecting channels, and the Saint Lawrence River.

Effective Date

The proposal is effective on the date of enactment.

[11] Under 46 U.S.C. 53101(1), the term "bulk cargo" means cargo that is loaded and carried in bulk without mark or count.

8. Restructure New York Liberty Zone tax incentives

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[12]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property. [13] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[14] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ

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[12] In addition to the NYLZ provisions described above, other NYLZ incentives are provided: (1) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property is authorized to be issued after March 9, 2002, and before January 1, 2010; and (2) $9 billion of additional tax-exempt advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

[13] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

[14] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

leasehold improvement property[15] and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[16] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001. [17]

Nonresidential real property and residential rental property are eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[18] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

<u>Depreciation of New York Liberty Zone leasehold improvements</u>

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[19] This rule applies regardless of whether the lessor or the

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[15] Qualified NYLZ leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as “qualified NYLZ leasehold improvement property” may be eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

[16] For purposes of this provision, purchase is defined as under section 179(d).

[17] Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

[18] December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

[19] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System (“ACRS”) to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with

lessee places the leasehold improvements in service.[20] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.[21]

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001, and before January 1, 2007 (and not subject to a binding contract on September 10, 2001), in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a nine-year recovery period. A taxpayer may elect out of the 5-year (and 9-year) recovery period for qualified NYLZ leasehold improvement property.

Increased section 179 expensing for qualified New York Liberty Zone property

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. The Small Business and Work Opportunity Tax Act of 2007[22] increased the amount a taxpayer may deduct, for taxable years beginning in 2007 through 2010, to $125,000 of the cost of qualifying property placed in service for the taxable year.[23] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2010 is treated as qualifying property. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after

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separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[20] Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

[21] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp. Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

[22] Pub. L. No. 110-28, sec. 8212 (2007).

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

2007 and before 2011.[24] In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased by the lesser of (1) $35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property for purposes of the NYLZ provision means section 179 property[25] purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.[26]

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The provision is effective for property placed in service after September 10, 2001, and before January 1, 2007.

<u>Extended replacement period for New York Liberty Zone involuntary conversions</u>

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period")

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[24] For taxable years beginning in 2011 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation.

[25] As defined in sec. 179(d)(1).

[26] See Rev. Proc. 2002-33, 2002-1 C.B. 963 (May 20, 2002), for procedures on claiming the increased section 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

property similar or related in service or use.[27] If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[28] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[29]

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

Description of Proposal

Repeal of certain NYLZ incentives

The proposal repeals the first-year depreciation allowance of 30 percent and the additional section 179 expensing in the case of nonresidential real property and residential rental property as of the date of enactment of this proposal.[30]

Creation of New York Liberty Zone Tax Credits

The proposal provides a credit against tax imposed for any payroll period by section 3402 (related to withholding for wages paid) for which a New York Liberty Zone governmental unit is liable under section 3403. The credit is equal to such portion of the qualifying project expenditure amounts allocated to the governmental unit for the calendar year that such governmental unit allocates to such period. The amount of the credit allowed for any payroll period shall be treated as a payment to the Secretary on the day on which the wages were paid to the employee, but only to the extent the governmental unit actually deducted and withheld such wages for the applicable period. A New York Liberty Zone governmental unit is the State of New York, the City of New York, or any agency or instrumentality of such State or city.

[27] Sec. 1033(a).

[28] Sec. 1033(a)(2)(B).

[29] Sec. 1033(g)(4).

[30] In the case of nonresidential real property and residential rental property acquired pursuant to a binding contract in effect on such enactment date, the first-year depreciation allowance of 30 percent and the additional section 179 expensing provisions terminate on December 31, 2009.

Qualifying project expenditure amount means, with respect to any calendar year, the sum of (1) the total expenditures paid or incurred during such calendar year by all New York Liberty Zone governmental units and the Port Authority of New York and New Jersey for any portion of qualifying projects located wholly within the City of New York, and (2) any such expenditures paid or incurred in any preceding calendar year beginning after the date of enactment of this proposal and not previously allocated.

A qualifying project is any transportation infrastructure project, including highways, mass transit systems, railroads, airports, ports, and waterways, in or connecting with the New York Liberty Zone, which is designated as a qualifying project by the Governor of the State of New York and the Mayor of the City of New York.

The Governor of the State of New York and the Mayor of the City of New York are to jointly allocate to each New York Liberty Zone governmental unit the portion of the qualifying expenditure amount that may be taken into account by such governmental unit to determine the credit for any calendar year in the credit period. The credit period is the 12-year period beginning on January 1, 2008. Aggregate amounts allocated may not exceed $2 billion during the credit period. There is also an annual limit on allocations equal to (1) $169 million for each year of the credit period, plus (2) any amounts in (1) that were authorized to be allocated for prior calendar years in the credit period but not so allocated.

If amounts allocated to a New York Liberty Zone governmental unit exceed the aggregate taxes for which such unit is liable under section 3403, the excess may be carried to the succeeding calendar year and added to the allocation for that calendar year. If a New York Liberty Zone governmental unit does not use an amount allocated to it within the time prescribed by the Governor of the State of New York and the Mayor of the City of New York, such amounts will be treated as if never allocated, and thus they may be reallocated by the Governor and Mayor.

Under the proposal, any expenditure for a qualifying project taken into account for purposes of the credit shall be considered State and local funds for the purpose of any Federal program.

The Governor of the State of New York and the Mayor of the City of New York must jointly submit to the Secretary an annual report that certifies the qualifying project expenditure amounts for the calendar year, the amount allocated to each New York Liberty Zone governmental unit, and any other such information as the Secretary may require.

Effective Date

The proposal is effective on the date of enactment.

9. Option to treat elective deferrals as after-tax contributions

Present Law

Among the various types of tax-favored retirement plans under present law are eligible deferred compensation plans under section 457(b). A section 457(b) plan is a plan maintained by a State or local government or a tax-exempt organization and that meets certain requirements. Generally, the maximum amount that can be deferred under a section 457(b) plan by an individual during any taxable year is limited to the lesser of 100 percent of the participant's includible compensation or the applicable dollar amount for the taxable year. The applicable dollar amount for 2007 is $15,500, and is indexed for future taxable years. A participant's includible compensation means the compensation of the participant from the eligible employer for the taxable year.

Over time, the rules relating to section 457(b) plans of State and local governments ("governmental section 457(b) plans") and those of tax-exempt entities have diverged. Some of the rules relating to governmental section 457(b) plans are similar to those relating to qualified retirement plans. For example, assets under a governmental section 457(b) plan are required to be held in trust for the exclusive benefit of plan participants. Compensation deferred under a governmental section 457(b) plan (and income attributable to the deferral) is generally includible in gross income only for the taxable year in which such compensation (and income) is paid. Rollovers between governmental section 457(b) plans and other tax-favored arrangements (subject to separate accounting requirements) are permitted.

Under present law, section 402A provides that an applicable retirement plan may include a qualified Roth contribution program. A qualified Roth contribution program means a program under which an employee may elect to make designated Roth contributions in lieu of all or a portion of the elective deferrals the employee is otherwise eligible to make under the applicable retirement plan. Designated Roth contributions are treated as elective deferrals (and thus, for example, subject to applicable nondiscrimination rules), except that designated Roth contributions are includible in an employee's gross income. Qualified distributions from a designated Roth account are excludable from gross income.

Applicable retirement plans permitted to include a Roth contribution program are plans qualified under Code section 401(a) and tax-sheltered annuities described in section 403(b). Elective deferral for purposes of a qualified Roth contribution program means an employer contribution under a qualified cash or deferred arrangement (within the meaning of section 401(k)) or an employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement.

As part of establishing a qualified Roth contribution program, an applicable retirement plan must establish a separate account, referred to as a designated Roth account, for the designated Roth contributions of each employee and any earnings on such contributions. In addition, the plan must maintain separate recordkeeping with respect to each account.

The maximum amount that can be designated as a Roth contribution by an employee for a taxable year is the maximum amount of elective deferrals that the employee could have excluded from gross income for the taxable year, less the aggregate elective deferrals that the employee does not designate as Roth contributions.

A qualified distribution from a designated Roth account generally means a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled. The nonexclusion period is the five-taxable-year period beginning with the earlier of (1) the first taxable year for which the participant made a designated Roth contribution to any designated Roth account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated Roth account that is the source of the distribution from a designated Roth account established for the participant under another plan, the first taxable year for which the participant made a designated Roth contribution to the previously established account.

Description of Proposal

Under the proposal, governmental section 457(b) plans may include a qualified Roth contribution program under which plan participants are permitted to designate elective deferrals that could be otherwise deferred under the plan as Roth contributions subject to the present-law rules. Thus, as under present law, such a designated Roth contribution is includible in gross income in the year of deferral and a subsequent distribution of such a contribution (and the income on such contribution) is excluded from gross income if the distribution is a qualified distribution. Similarly, the present-law separate accounting requirements apply to qualified Roth contribution programs permitted under the proposal.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2007.

10. Increase in information return penalties

Present Law

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721 of the Code, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, of any year, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 of the Code also imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

Description of Proposal

The proposal increases the penalties for failing to file correct information returns, failing to furnish correct payee statements, and for failing to comply with other information reporting requirements. Specifically, the proposal increases the failure to file correct information returns as follows: the first-tier penalty would be increased from $15 to $50, with a maximum penalty of $500,000 per calendar year; the second-tier penalty would be increased from $30 to $100, with a maximum penalty of $1,500,000 per calendar year; and the third-tier penalty would be increased from $50 to $250, with a maximum penalty of $3,000,000 per calendar year. The maximum penalties for small businesses would be: $175,000 if the failures are corrected on or before 30 days after the prescribed filing date; $500,000 if the failures are corrected on or before August 1; and $1,000,000 if the failures are not corrected on or before August 1.

The proposal increases both the penalty for failing to furnish correct payee statements to taxpayers and the penalty for failing to comply with other information reporting requirements penalties to $250 for each such failure, up to a maximum of $1,000,000 in a calendar year.

Effective Date

The proposal is effective with respect to information returns required to be filed on or after January 1, 2008.