

**TECHNICAL EXPLANATION OF THE
REVENUE PROVISIONS CONTAINED IN THE “TAX RELIEF,
UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB
CREATION ACT OF 2010” SCHEDULED FOR CONSIDERATION
BY THE UNITED STATES SENATE**

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions contained in the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” scheduled for consideration by the United States Senate.

¹ This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” Scheduled for Consideration by the United States Senate* (JCX-55-10), December 10, 2010. Revenue estimates for the provisions described in this document are contained in JCX-54-10, *Estimated Budget Effects of the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,” Scheduled for Consideration by the United States Senate*. These documents can also be found on our website at www.jct.gov.

TITLE I – TEMPORARY EXTENSION OF TAX RELIEF

A. Marginal Individual Income Tax Rate Reductions (sec. 101 of the bill and sec. 1 of the Code)

Present Law

In general

The Economic Growth and Tax Relief Reconciliation Act of 2001² (“EGTRRA”) created a new 10-percent regular income tax bracket for a portion of taxable income that was previously taxed at 15 percent. EGTRRA also reduced the other regular income tax rates. The otherwise applicable regular income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent, respectively. These provisions of EGTRRA shall cease to apply for taxable years beginning after December 31, 2010.

Tax rate schedules

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer’s income increases. Separate rate schedules apply based on an individual’s filing status. For 2010, the regular individual income tax rate schedules are as follows:

² Pub. L. No. 107-16.

Table 1.—Federal Individual Income Tax Rates for 2010

| If taxable income is: | Then income tax equals: |
|--|--|
| Single Individuals | |
| Not over \$8,375 | 10% of the taxable income |
| Over \$8,375 but not over \$34,000 | \$837.50 plus 15% of the excess over \$8,375 |
| Over \$34,000 but not over \$82,400 | \$4,681.25 plus 25% of the excess over \$34,000 |
| Over \$82,400 but not over \$171,850 | \$16,781.25 plus 28% of the excess over \$82,400 |
| Over \$171,850 but not over \$373,650 | \$41,827.25 plus 33% of the excess over \$171,850 |
| Over \$373,650 | \$108,421.25 plus 35% of the excess over \$373,650 |
| Heads of Households | |
| Not over \$11,950 | 10% of the taxable income |
| Over \$11,950 but not over \$45,550 | \$1,195 plus 15% of the excess over \$11,950 |
| Over \$45,550 but not over \$117,650 | \$6,235 plus 25% of the excess over \$45,550 |
| Over \$117,650 but not over \$190,550 | \$24,260 plus 28% of the excess over \$117,650 |
| Over \$190,550 but not over \$373,650 | \$44,672 plus 33% of the excess over \$190,550 |
| Over \$373,650 | \$105,095 plus 35% of the excess over \$373,650 |
| Married Individuals Filing Joint Returns and Surviving Spouses | |
| Not over \$16,750 | 10% of the taxable income |
| Over \$16,750 but not over \$68,000 | \$1,675 plus 15% of the excess over \$16,750 |
| Over \$68,000 but not over \$137,300 | \$9,362.50 plus 25% of the excess over \$68,000 |
| Over \$137,300 but not over \$209,250 | \$26,687.50 plus 28% of the excess over \$137,300 |
| Over \$209,250 but not over \$373,650 | \$46,833.50 plus 33% of the excess over \$209,250 |
| Over \$373,650 | \$101,085.50 plus 35% of the excess over \$373,650 |
| Married Individuals Filing Separate Returns | |
| Not over \$8,375 | 10% of the taxable income |
| Over \$8,375 but not over \$34,000 | \$837.50 plus 15% of the excess over \$8,375 |
| Over \$34,000 but not over \$68,650 | \$4,681.25 plus 25% of the excess over \$34,000 |
| Over \$68,650 but not over \$104,625 | \$13,343.75 plus 28% of the excess over \$68,650 |
| Over \$104,625 but not over \$186,825 | \$23,416.75 plus 33% of the excess over \$104,625 |
| Over \$186,825 | \$50,542.75 plus 35% of the excess over \$186,825 |

Explanation of Provision

The provision extends the 10-percent, 15-percent, 25-percent, 28-percent, 33-percent and 35-percent individual income tax rates for two years (through 2012).

The rate structure is indexed for inflation.

A comparison of Table 2, below, with Table 1, above, illustrates the tax rate changes. Note that Table 2 also incorporates the provision to retain the marriage penalty relief with respect to the size of the 15 percent rate bracket, as discussed below.

Table 2.—Federal Individual Income Tax Rates for 2011

| If taxable income is: | Then income tax equals: |
|---|--|
| Single Individuals | |
| Not over \$8,500 | 10% of the taxable income |
| Over \$8,500 but not over \$34,500 | \$850 plus 15% of the excess over \$8,500 |
| Over \$34,500 but not over \$83,600 | \$4,750 plus 25% of the excess over \$34,500 |
| Over \$83,600 but not over \$174,400 | \$17,025 plus 28% of the excess over \$83,600 |
| Over \$174,400 but not over \$379,150 | \$42,449 plus 33% of the excess over \$174,400 |
| Over \$379,150 | \$110,016.50 plus 35% of the excess over \$379,150 |
| Heads of Households | |
| Not over \$12,150 | 10% of the taxable income |
| Over \$12,150 but not over \$46,250 | \$1,215 plus 15% of the excess over \$12,150 |
| Over \$46,250 but not over \$119,400 | \$6,330 plus 25% of the excess over \$46,250 |
| Over \$119,400 but not over \$193,350 | \$24,617.50 plus 28% of the excess over \$119,350 |
| Over \$193,350 but not over \$379,150 | \$45,323.50 plus 33% of the excess over \$193,350 |
| Over \$379,150 | \$106,637.50 plus 35% of the excess over \$379,150 |
| Married Individuals Filing Joint Returns and Surviving Spouses | |
| Not over \$17,000 | 10% of the taxable income |
| Over \$17,000 but not over \$69,000 | \$1,700 plus 15% of the excess over \$17,000 |
| Over \$69,000 but not over \$139,350 | \$9,500 plus 25% of the excess over \$69,000 |
| Over \$139,350 but not over \$212,300 | \$27,087.50 plus 28% of the excess over \$139,350 |
| Over \$212,300 but not over \$379,150 | \$47,513.50 plus 33% of the excess over \$379,150 |
| Over \$379,150 | \$102,574 plus 35% of the excess over \$379,150 |
| Married Individuals Filing Separate Returns | |
| Not over \$8,500 | 10% of the taxable income |
| Over \$8,500 but not over \$34,500 | \$850 plus 15% of the excess over \$8,500 |
| Over \$34,500 but not over \$69,675 | \$4,750 plus 25% of the excess over \$34,500 |
| Over \$69,675 but not over \$106,150 | \$13,543.75 plus 28% of the excess over \$69,675 |
| Over \$106,150 but not over \$189,575 | \$23,756.75 plus 33% of the excess over \$106,150 |
| Over \$189,575 | \$51,287 plus 35% of the excess over \$189,575 |

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

**B. The Overall Limitation on Itemized Deductions
and the Personal Exemption Phase-Out
(sec. 101 of the bill and secs. 68 and 151 of the Code)**

Present Law

Overall limitation on itemized deductions (“Pease” limitation)

Unless an individual elects to claim the standard deduction for a taxable year, the taxpayer is allowed to deduct his or her itemized deductions. Itemized deductions generally are those deductions which are not allowed in computing adjusted gross income (“AGI”). Itemized deductions include unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Prior to 2010, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was limited for upper-income taxpayers. In computing this reduction of total itemized deductions, all limitations applicable to such deductions (such as the separate floors) were first applied and, then, the otherwise allowable total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer’s AGI exceeded a threshold amount which was indexed annually for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent.

EGTRRA repealed this overall limitation on itemized deductions with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007; (2) a two-thirds reduction in 2008, and 2009; and (3) no overall limitation on itemized deductions in 2010. Thus in 2009, for example, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) was reduced by three percent of the amount of the taxpayer’s AGI in excess of \$166,800 (\$83,400 for married couples filing separate returns). Then the overall reduction in itemized deductions was phased-down to 1/3 of the full reduction amount (that is, the limitation was reduced by two-thirds).

Pursuant to the general EGTRRA sunset, the phased-in repeal of the Pease limitation sunsets and the limitation becomes fully effective again in 2011. Adjusting for inflation, the AGI threshold is \$169,550 for 2011.

Personal exemption phase-out for certain taxpayers (“PEP”)

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is \$3,650. This amount is indexed annually for inflation.

Prior to 2010, the deduction for personal exemptions was reduced or eliminated for taxpayers with incomes over certain thresholds, which were indexed annually for inflation. Specifically, the total amount of exemptions that could be claimed by a taxpayer was reduced by

two percent for each \$2,500 (or portion thereof) by which the taxpayer's AGI exceeded the applicable threshold. (The phase-out rate was two percent for each \$1,250 for married taxpayers filing separate returns.) Thus, the deduction for personal exemptions was phased out over a \$122,500 range (which was not indexed for inflation), beginning at the applicable threshold.

In 2009, for example, the applicable thresholds were \$166,800 for single individuals, \$250,200 for married individuals filing a joint return and surviving spouses, \$208,500 for heads of households, and \$125,100 for married individuals filing separate returns.

EGTRRA repealed PEP with the repeal phased-in over five years. EGTRRA provided: (1) a one-third reduction of the otherwise applicable limitation in 2006 and 2007; (2) a two-thirds reduction in 2008, and 2009; and (3) no PEP in 2010. However, under the EGTRRA sunset, the PEP becomes fully effective again in 2011. Adjusted for inflation, the PEP thresholds for 2011 are: (1) \$169,550 for unmarried individuals; (2) \$254,350 for married couples filing joint returns; and (3) \$211,950 for heads of households.

Explanation of Provision

Overall limitation on itemized deductions ("Pease" limitation)

Under the provision the overall limitation on itemized deductions does not apply for two additional years (through 2012).

Personal exemption phase-out for certain taxpayers ("PEP")

Under the provision the personal exemption phase-out does not apply for two additional years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

C. Child Tax Credit
(secs. 101 and 103 of the bill and sec. 24 of the Code)

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum amount of the credit per child is \$1,000 through 2010 and \$500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income (“modified AGI”) over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax (“AMT”). To the extent the child tax credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the “earned income” formula). EGTRRA provided, in general, that this threshold dollar amount is \$10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 (“ARRA”)³ set the threshold at \$3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the “alternative formula” if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer’s social security taxes exceed the taxpayer’s earned income tax credit (“EITC”). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

³ Pub. L. No.111-5.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but are excluded from gross income for individual income tax purposes. Therefore, these allowances are not considered earned income for purposes of the additional child tax credit.

Explanation of Provision

The provision extends the \$1,000 child tax credit and allows the child tax credit against the individual's regular income tax and AMT for two years (through 2012). The provision also extends the EGTRRA repeal of a prior-law provision that reduced the refundable child credit by the amount of the AMT for two years (through 2012). The provision extends the earned income formula for determining the refundable child credit, with the earned income threshold of \$3,000 (also, the provision stops indexation for inflation of the \$3,000 earnings threshold) for two years (through 2012).⁴ Finally, the provision extends the rule that the refundable portion of the child tax credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds for two years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

⁴ Section 101 of the bill extends the EGTRRA modifications to the provision. Section 103 of the bill extends the modifications to the provision (including reduction in the earnings threshold for the refundable portion of the child tax credit to \$3,000). See Title I, section J for additional discussion of the child tax credit.

**D. Marriage Penalty Relief and Earned Income Tax Credit Simplification
(sec. 101 of the bill and secs. 1, 32, and 63 of the Code)**

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately continued to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately are the same.

Fifteen percent rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return.

Earned income tax credit

The earned income tax credit (“EITC”) is a refundable credit available to certain low-income taxpayers. Generally, the amount of an individual’s allowable earned income credit is dependent on the individual’s earned income, adjusted gross income, the number of qualifying children and (through 2010) filing status.

Explanation of Provision

Basic standard deduction

The provision increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return for two years (through 2012).

Fifteen percent rate bracket

The provision increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the 15-percent regular income tax rate bracket for an unmarried individual filing a single return for two years (through 2012).

Earned income tax credit

The provision extends certain EITC provisions adopted by EGTRRA for two years (through 2012). These include: (1) a simplified definition of earned income; (2) a simplified relationship test; (3) use of AGI instead of modified AGI; (4) a simplified tie-breaking rule; (5) additional math error authority for the Internal Revenue Service; (6) a repeal of the prior-law provision that reduced an individual’s EITC by the amount of his alternative minimum tax liability; and (7) increases in the beginning and ending points of the credit phase-out for married taxpayers by \$5,000.⁵

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

⁵ The amount is indexed for inflation annually. See Title I, section K for a more complete description of the EITC.

E. Education Incentives
(sec. 101 of the bill and secs. 117, 127, 142, 146-148, 221, and 530 of the Code)

Present Law

Income and wage exclusion for awards under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations. Amounts excludable from gross income under section 117 are also excludable from wages for payroll tax purposes.⁶

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. An exception to this rule applies in the case of the National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”).

The NHSC Scholarship Program and the Armed Forces Scholarship Program provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Under the sunset provisions of EGTRRA, the exclusion from gross income and wages for the NHSC Scholarship Program and the Armed Forces Scholarship Program will no longer apply for taxable years beginning after December 31, 2010.

⁶ Sec. 3121(a)(20).

Income and wage exclusion for employer-provided educational assistance

If certain requirements are satisfied, up to \$5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes.⁷ This exclusion applies to both graduate and undergraduate courses.⁸ For the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, or (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee (e.g., it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit.⁹ In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law, or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to

⁷ Secs. 127, 3121(a)(18).

⁸ The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2010 (under EGTRRA's sunset provision).

⁹ Sec. 132(d).

education or training that enables a taxpayer to begin working in a new trade or business. In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended 10 times.¹⁰ EGTRRA deleted the exclusion's explicit expiration date and extended the exclusion to graduate courses. However, those changes are subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.¹¹

Deduction for student loan interest

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit.¹² Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending an eligible educational institution on at least a half-time basis. Eligible educational institutions are (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Additionally, to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

The maximum allowable deduction per year is \$2,500. For 2010, the deduction is phased out ratably for single taxpayers with AGI between \$60,000 and \$75,000 and between \$120,000 and \$150,000 for married taxpayers filing a joint return. The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

¹⁰ The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

¹¹ Treas. Reg. sec. 1.162-5.

¹² Sec. 221.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire are: (1) increases that were made in the AGI phaseout ranges for the deduction and (2) rules that extended deductibility of interest beyond the first 60 months that interest payments are required. With the expiration of EGTRRA, the phaseout ranges will revert to a base level of \$40,000 to \$55,000 (\$60,000 to \$75,000 in the case of a married couple filing jointly), but with an adjustment for inflation occurring since 2002.

Coverdell education savings accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.¹³ Annual contributions to Coverdell education savings accounts may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.¹⁴ However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.¹⁵

Tax-free (including free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary education expenses.”

¹³ Sec. 530.

¹⁴ In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

¹⁵ This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.¹⁶ Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.¹⁷

The term “qualified elementary and secondary education expenses,” means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary education expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee’s gross income under section 127.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire are: (1) the increase in the contribution limit to \$2,000 from \$500; (2) the increase in the phaseout range for married taxpayers filing jointly to \$190,000-\$220,000 from \$150,000-\$160,000; (3) the expansion of qualified expenses to include elementary and secondary education expenses; (4) special age rules for special needs beneficiaries; (5) clarification that corporations and other entities are permitted to make contributions, regardless of the income of the corporation or entity during the year of the contribution; (6) certain rules regarding when

¹⁶ Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

¹⁷ Sec. 530(b)(2)(B).

contributions are deemed made and extending the time during which excess contributions may be returned without additional tax; (7) certain rules regarding coordination with the Hope and Lifetime Learning credits; and (8) certain rules regarding coordination with qualified tuition programs.

Amount of governmental bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception

To prevent State and local governments from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds.¹⁸ The Code also provides certain exceptions to the arbitrage restrictions. Under one such exception, small issuers of governmental bonds issued for local governmental activities are not subject to the rebate requirement.¹⁹ To qualify for this exception the governmental bonds must be issued by a governmental unit with general taxing powers that reasonably expects to issue no more than \$5 million of tax-exempt governmental bonds in a calendar year.²⁰ Prior to EGTRRA, the \$5 million limit was increased to \$10 million if at least \$5 million of the bonds are used to finance public schools. EGTRRA provided the additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from \$5 million to \$10 million.²¹ Thus, these governmental units may issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds are used to finance public school construction expenditures. This increase is subject to the EGTRRA sunset.

Issuance of tax-exempt private activity bonds for public school facilities

Interest on bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue act. These bonds are

¹⁸ The exclusion from gross income for interest on State and local bonds does not apply to any arbitrage bond (sec. 103(a), (b)(2)). A bond is an arbitrage bond if it is part of an issue that violates the restrictions against investing in higher-yielding investments under section 148(a) or that fails to satisfy the requirement to rebate arbitrage earnings under section 148(f).

¹⁹ Ninety-five percent or more of the net proceeds of governmental bond issue are to be used for local governmental activities of the issuer. Sec. 148(f)(4)(D).

²⁰ Under the Treasury regulations, an issuer may apply a fact-based rather than an expectations-based test. Treas. Reg. 1.148-8(c)(1).

²¹ Sec. 148(f)(4)(D)(vii).

called “private activity bonds.”²² The term “private person” includes the Federal government and all other individuals and entities other than State or local governments.

Only specified private activity bonds are tax-exempt. EGTRRA added a new type of private activity bond that is subject to the EGTRRA sunset. This category is bonds for elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency.²³ The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes, or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-State private activity bond volume limit equal to \$10 per resident (\$5 million, if greater) in lieu of the present-law State private activity bond volume limits. As with the present-law State private activity bond volume limits, States can decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

Explanation of Provision

The provision delays the EGTRRA sunset as it applies to the NHSC Scholarship Program and the Armed Forces Scholarship Program, the section 127 exclusion from income and wages for employer-provided educational assistance, the student loan interest deduction, and Coverdell education savings accounts for two years. The provision also delays the EGTRRA sunset as it applies to the expansion of the small government unit exception to arbitrage rebate and allowing issuance of tax-exempt private activity bonds for public school facilities. Thus, all of these tax benefits for education continue to be available through 2012.

Effective Date

The provision is effective on the date of enactment.

²² The Code provides that the exclusion from gross income does not apply to interest on private activity bonds that are not qualified bonds within the meaning of section 141. See secs. 103(b)(1), 141.

²³ Sec. 142(a)(13), (k).

F. Other Incentives for Families and Children
(includes extension of the adoption tax credit, employer-provided
child care tax credit, and dependent care tax credit)
(sec. 101 of the bill and secs. 21, 23, 36C, 45D, and 137 of the Code)

Present Law

Adoption credit and exclusion from income for employer-provided adoption assistance

Present law for 2010 provides: (1) a maximum adoption credit of \$13,170 per eligible child (both special needs and non-special needs adoptions); and (2) a maximum exclusion of \$13,170 per eligible child (both special needs and non-special needs adoptions).²⁴ These dollar amounts are adjusted annually for inflation. These benefits are phased-out over a \$40,000 range for taxpayers with modified adjusted gross income (“modified AGI”) in excess of certain dollar levels. For 2010, the phase-out range is between \$182,520 and \$222,520. The phase-out threshold is adjusted for inflation annually, but the phase-out range remains a \$40,000 range.

For taxable years beginning after December 31, 2011, the adoption credit and employer-provided adoption assistance exclusion are available only to special needs adoptions and the maximum credit and exclusion are reduced to \$6,000, respectively. The phase-out range is reduced to lower income levels (i.e., between \$75,000 and \$115,000). The maximum credit, exclusion, and phase-out range are not indexed for inflation.

Employer-provided child care tax credit

Taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. The maximum total credit that may be claimed by a taxpayer cannot exceed \$150,000 per taxable year.

Qualified child care expenses include costs paid or incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer’s qualified child care facility; (2) for the operation of the taxpayer’s qualified child care facility, including the costs of training and certain compensation for employees of the child care facility, and scholarship programs; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care (unless it is the principal residence of the taxpayer), and the facility must meet all applicable State and local laws and regulations, including any licensing laws. A facility

²⁴ EGTRRA increased the maximum credit and exclusion to \$10,000 (indexed for inflation after 2002) for both non-special needs and special needs adoptions, increased the phase-out starting point to \$150,000 (indexed for inflation after 2002), and allowed the credit against the AMT. Section 10909 of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148): (1) extended the EGTRRA expansion of the adoption credit and exclusion from income for employer-provided adoption assistance for one year (for 2011); (2) increased by \$1,000 (to \$13,170, indexed for inflation) the maximum adoption credit and exclusion from income for employer-provided adoption assistance for two years (2010 and 2011); and (3) made the credit refundable for two years (2010 and 2011).

is not treated as a qualified child care facility with respect to a taxpayer unless: (1) it has open enrollment to the employees of the taxpayer; (2) use of the facility (or eligibility to use such facility) does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code); and (3) at least 30 percent of the children enrolled in the center are dependents of the taxpayer's employees, if the facility is the principal trade or business of the taxpayer. Qualified child care resource and referral expenses are amounts paid or incurred under a contract to provide child care resource and referral services to the employees of the taxpayer. Qualified child care services and qualified child care resource and referral expenditures must be provided (or be eligible for use) in a way that does not discriminate in favor of highly compensated employees of the taxpayer (within the meaning of section 414(q) of the Code).

Any amounts for which the taxpayer may otherwise claim a tax deduction are reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credits.

Credits taken for the expenses of acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture for the first ten years after the qualified child care facility is placed in service. The amount of recapture is reduced as a percentage of the applicable credit over the 10-year recapture period. Recapture takes effect if the taxpayer either ceases operation of the qualified child care facility or transfers its interest in the qualified child care facility without securing an agreement to assume recapture liability for the transferee. The recapture tax is not treated as a tax for purposes of determining the amount of other credits or determining the amount of the alternative minimum tax. Other rules apply.

This tax credit expires for taxable years beginning after December 31, 2010.

Dependent care tax credit

The maximum dependent care tax credit is \$1,050 (35 percent of up to \$3,000 of eligible expenses) if there is one qualifying individual, and \$2,100 (35 percent of up to \$6,000 of eligible expenses) if there are two or more qualifying individuals. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each \$2,000 (or fraction thereof) of adjusted gross income ("AGI") above \$15,000. Therefore, the credit percentage is reduced to 20 percent for taxpayers with AGI over \$43,000.

The level of this credit is reduced for taxable years beginning after December 31, 2010, under the EGTRRA sunset.

Explanation of Provision

Adoption credit and exclusion from income for employer-provided adoption assistance

The provision extends the EGTRRA expansion of these two benefits for one year (2012). Therefore, for 2012, the maximum benefit is \$12,170 (indexed for inflation after 2010). The

adoption credit and exclusion are phased out ratably for taxpayers with modified adjusted gross income between \$182,520 and \$222,520 (indexed for inflation after 2010).²⁵

Employer-provided child care tax credit

The provision extends this tax benefit for two years (through 2012).

Expansion of dependent care tax credit

The provision extends the dependent care tax credit EGTRRA expansion for two years (through 2012).

Effective Date

The provisions apply to taxable years beginning after December 31, 2010.

²⁵ The changes to the adoption credit and exclusion from employer-provided adoption assistance for 2010 and 2011 (relating to the \$1,000 increase in the maximum credit and exclusion and the refundability of the credit) enacted as part of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) are not extended by the provision.

G. Alaska Native Settlement Trusts
(sec. 101 of the bill and sec. 646 of the Code)

Present Law

The Alaska Native Claims Settlement Act (“ANCSA”)²⁶ established Alaska Native Corporations to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless an Alaska Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits an Alaska Native Corporation to transfer money or other property to an Alaska Native Settlement Trust (“Settlement Trust”) for the benefit of beneficiaries who constitute all or a class of the shareholders of the Alaska Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.²⁷

Alaska Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by an Alaska Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from an Alaska Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period. Amounts distributed in excess of the amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Alaska Native Corporation in the year of distribution by the Trust, which means that the beneficiaries

²⁶ 43 U.S.C. 1601 *et. seq.*

²⁷ With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Alaska Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Alaska Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Alaska Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of an Alaska Native Corporation that is caused by a transfer of assets from the Alaska Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under Section 6034A.

The earnings and profits of an Alaska Native Corporation are not reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the Alaska Native Corporation earnings and profits are reduced as and when distributions are thereafter made by the electing Trust that are taxed to the beneficiaries as dividends from the Alaska Native Corporation to the beneficiaries.

The election to pay tax at the lowest rate is not available in certain disqualifying cases: (a) where transfer restrictions have been modified either to allow a transfer of a beneficial interest that would not be permitted by section 7(h) of the Alaska Native Claims Settlement Act if the interest were Settlement Common stock, or (b) where transfer restrictions have been modified to allow a transfer of any Stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement Common Stock and the Alaska Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying situations, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.²⁸

Explanation of Provision

The provision delays for two years the EGTRRA sunset as it applies to electing Settlement Trusts.

²⁸ These provisions were enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, sec. 671 (June 7, 2001), scheduled to sunset in taxable years beginning after December 31, 2010. See H.R. Rep. No. 107-84 (2001).

Effective Date

The provision is effective for taxable years of electing Settlement Trusts, their beneficiaries, and sponsoring Alaska Native Corporations beginning after December 31, 2010.

H. Reduced Rate on Dividends and Capital Gains (sec. 102 of the bill and sec. 1(h) of the Code)

Present Law

Dividends

In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

Tax rates before 2011

An individual's qualified dividend income is taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2011, an individual's qualified dividend income is taxed at rates of zero and 15 percent. The zero-percent rate applies to qualified dividend income which otherwise would be taxed at a 10- or 15-percent rate if the special rates did not apply.

Qualified dividend income generally includes dividends received from domestic corporations and qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company (“RIC”) for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (1) the qualified dividend income of the RIC for the taxable year and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust (“REIT”) for any taxable year may not exceed the sum of (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers’ cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.²⁹

Tax rates after 2010

For taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income tax rates.

Capital gains

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

²⁹ In addition, for taxable years beginning before 2011, amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Tax rates before 2011

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate. These rates apply for purposes of both the regular tax and the AMT.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies may not exceed the net section 1231 gain for the year.

An individual's unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

Tax rates after 2010

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital gain rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2011.

Explanation of Provision

Under the provision, the regular and minimum tax rates for qualified dividend income and capital gain in effect before 2011 are extended for two additional years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

**I. Extend American Opportunity Tax Credit
(sec. 103 of the bill and sec. 25A of the Code)**

Present Law

Hope credit

For taxable years beginning before 2009 and after 2010, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,800 (for 2008) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100 percent on the first \$1,200 of qualified tuition and related expenses, and 50 percent on the next \$1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phaseout described below) for a \$1,200 Hope credit. If a taxpayer incurs \$2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,800 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$48,000 and \$58,000 (\$96,000 and \$116,000 for married taxpayers filing a joint return) for 2008. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of \$1,000. The size of the phaseout ranges are always \$10,000 and \$20,000 respectively.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

The Hope credit is available for “qualified tuition and related expenses,” which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student’s degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor’s degree, an associate’s degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The principal EGTRRA change scheduled to expire is the change that permits a taxpayer to claim a Hope credit in the same year that he or she claims an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

American opportunity tax credit

The American Opportunity Tax Credit refers to modifications to the Hope credit that apply for taxable years beginning in 2009 or 2010. The maximum allowable modified credit is \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the

first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

Under the provision, the modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

Bona fide residents of the U.S. possessions are not permitted to claim the refundable portion of the modified credit in the United States. Rather, a bona fide resident of a mirror code possession (Commonwealth of the Northern Mariana Islands, Guam, and the Virgin Islands) may claim the refundable portion of the credit in the possession in which the individual is a resident. Similarly, a bona fide resident of a non-mirror code possession (Commonwealth of Puerto Rico and American Samoa) may claim the refundable portion of the credit in the possession in which the individual is resident, but only if the possession establishes a plan for permitting the claim under its internal law. The U.S. Treasury will make payments to the possession in respect of credits allowable to their residents under their internal laws.

Explanation of Provision

The provision extends for two years (through 2012) the temporary modifications to the Hope credit for taxable years beginning in 2009 and 2010 that are known as the American Opportunity Tax Credit, including the rules governing the treatment of the U.S. possessions.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.

J. Child Tax Credit
(sec. 103 of the bill and sec. 24 of the Code)

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The maximum amount of the credit per child is \$1,000 through 2010 and \$500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable aggregate child tax credit amount is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income (“modified AGI”) over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2011, is allowed against the alternative minimum tax (“AMT”). To the extent the child tax credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the “earned income” formula). EGTRRA provided, in general, that this threshold dollar amount is \$10,000 indexed for inflation from 2001. The American Recovery and Reinvestment Act of 2009 set the threshold at \$3,000 for both 2009 and 2010. After 2010, the ability to determine the refundable child credit based on earned income in excess of the threshold dollar amount expires.

Families with three or more qualifying children may determine the additional child tax credit using the “alternative formula” if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer’s social security taxes exceed the taxpayer’s earned income tax credit (“EITC”). After 2010, due to the expiration of the earned income formula, this is the only manner of obtaining a refundable child credit.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers’ parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Explanation of Provision

The provision extends for two years the earned income threshold of \$3,000. Also, the provision stops indexation for inflation of the \$3,000 earnings threshold for that period.

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

**K. Increase in the Earned Income Tax Credit
(sec. 103 of the bill and sec. 32 of the Code)**

Present Law

Overview

Low- and moderate-income workers may be eligible for the refundable earned income tax credit (“EITC”). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker’s family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (“AGI”), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,100 (for 2010). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer’s Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing status

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$5,980, resulting in a maximum credit of \$457 for 2010. The maximum is available for those with incomes between \$5,980 and \$7,480 (\$12,490 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above \$7,480 (\$12,480 if married filing jointly) resulting in a \$0 credit at \$13,460 of earnings (\$18,470 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2010 of 34 percent of their earnings up to \$8,970, resulting in a maximum credit of \$3,050. The maximum credit is available for those with earnings between \$8,970 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 15.98 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$35,535 of earnings (\$40,545 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2010 of 40 percent of earnings up to \$12,590, resulting in a maximum credit of \$5,036. The maximum credit is available for those with earnings between \$12,590 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$40,363 of earnings (\$45,373 if married filing jointly).

A temporary provision enacted by ARRA allows taxpayers with three or more qualifying children to claim a credit of 45 percent for 2009 and 2010. For example, in 2010 taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to \$12,590, resulting in a maximum credit of \$5,666. The maximum credit is available for those with earnings between \$12,590 and \$16,450 (\$21,460 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above \$16,450 (\$21,460 if married filing jointly). The credit is completely phased out at \$43,352 of earnings (\$48,362 if married filing jointly).

Under another provision of ARRA, the phase-out thresholds for married couples were raised to an amount \$5,000 above that for other filers for 2009 (and indexed for inflation). The increase is \$5,010 for 2010. Formerly, the phase-out thresholds for married couples were \$3,000 (indexed for inflation from 2008) greater than those for other filers as provided for in EGTRRA.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and

taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

Explanation of Provision

The provision extends the EITC at a rate of 45 percent for three or more qualifying children for two years (through 2012).

The provision extends the higher phase-out thresholds for married couples filing joint returns enacted as part of ARRA for two years (through 2012).

Effective Date

The provision applies to taxable years beginning after December 31, 2010.

TITLE II – TEMPORARY EXTENSION OF INDIVIDUAL ALTERNATIVE MINIMUM TAX RELIEF

A. Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits and Increased Alternative Minimum Tax Exemption Amount (secs. 201 and 202 of the bill and secs. 26 and 55 of the Code)

Present Law

Present law imposes an alternative minimum tax (“AMT”) on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual’s tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income (“AMTI”) as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual’s taxable income adjusted to take account of specified preferences and adjustments.

The exemption amounts are: (1) \$70,950 for taxable years beginning in 2009 and \$45,000 in taxable years beginning after 2009 in the case of married individuals filing a joint return and surviving spouses; (2) \$46,700 for taxable years beginning in 2009 and \$33,750 in taxable years beginning after 2009 in the case of other unmarried individuals; (3) \$35,475 for taxable years beginning in 2009 and \$22,500 in taxable years beginning after 2009 in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual’s AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the child credit, the credit for interest on certain home mortgages, the Hope Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, the credit for certain plug-in electric vehicles, the credit for alternative motor vehicles, the credit for new qualified plug-in electric drive motor vehicles, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2010, the nonrefundable personal credits are allowed to the extent of the full amount of the individual’s regular tax and alternative minimum tax.

For taxable years beginning after 2009, the nonrefundable personal credits (other than the child credit, the credit for savers, the credit for residential energy efficient property, the credit for certain plug-in electric drive motor vehicles, the credit for alternative motor vehicles, and credit for new qualified plug-in electric drive motor vehicles) are allowed only to the extent that the individual’s regular income tax liability exceeds the individual’s tentative minimum tax,

determined without regard to the minimum tax foreign tax credit. The remaining nonrefundable personal credits are allowed to the full extent of the individual's regular tax and alternative minimum tax.³⁰

Explanation of Provisions

The provision allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits for 2010 and 2011.

The provision provides that the individual AMT exemption amount for taxable years beginning in 2010 is (1) \$72,450, in the case of married individuals filing a joint return and surviving spouses; (2) \$47,450 in the case of other unmarried individuals; and (3) \$36,225 in the case of married individuals filing separate returns.

The provision provides that the individual AMT exemption amount for taxable years beginning in 2011 is (1) \$74,450, in the case of married individuals filing a joint return and surviving spouses; (2) \$48,450 in the case of other unmarried individuals; and (3) \$37,225 in the case of married individuals filing separate returns.

Effective Date

The provision is effective for taxable years beginning after 2009.

³⁰ The rule applicable to the child credit after 2010 is subject to the EGTRRA sunset. The adoption credit is refundable in 2010 and 2011 and beginning in 2012 is nonrefundable and treated for purposes of the AMT in the same manner as the child credit.

TITLE III – TEMPORARY ESTATE TAX RELIEF

A. Modify and Extend the Estate, Gift, and Generation Skipping Transfer Taxes After 2009 (sections 301-304 of the bill and sections 2001, 2010, 2502, 2505, 2511, 2631, and 6018 of the Code)

Present and Prior Law

In general

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

The estate and generation skipping transfers taxes are repealed for decedents dying and gifts made during 2010, but are reinstated for decedents dying and gifts made after 2010.

Exemption equivalent amounts and applicable tax rates

In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death.³¹ The unified credit offsets tax computed at the lowest estate and gift tax rates.

Before 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continued to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes was higher than the effective exemption amount allowed for gift tax purposes. In 2009, the highest estate and gift tax rate was 45 percent. The unified credit effective exemption amount was \$3.5 million for estate tax purposes and \$1 million for gift tax purposes.

For 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to and after repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

³¹ Sec. 2010.

Repeal of estate and generation skipping transfer taxes in 2010; modifications to gift tax

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a \$1 million exemption amount and a gift tax rate of 35 percent. Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010

The estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) do not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of \$1 million applies for purposes of determining the tax on cumulative taxable transfers by lifetime gift or bequest.

Basis in property received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property.³² Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Property received from a donor of a lifetime gift generally takes a carryover basis.³³ "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of

³² Sec. 1001.

³³ Sec. 1015.

property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

Basis in property received from a decedent who died in 2009

Property passing from a decedent who died during 2009 generally takes a "stepped-up" basis.³⁴ In other words, the basis of property passing from such a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate).³⁵ This step up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

Basis in property received from a decedent who dies during 2010

The rules providing for stepped-up basis in property acquired from a decedent are repealed for assets acquired from decedents dying in 2010, and a modified carryover basis regime applies.³⁶ Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

³⁴ Sec. 1014.

³⁵ There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of "income in respect of a decedent." Sec. 1014(c). The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was in the hands of the decedent) increased by estate tax paid on that asset. Income in respect of a decedent includes rights to income that has been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under 2009 law, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

³⁶ Sec. 1022.

An executor generally may increase the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of \$1.3 million. The \$1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to \$60,000. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. Thus, the basis of property transferred to surviving spouses generally may be increased by up to \$4.3 million.

Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010

As a result of the EGTRRA sunset at the end of 2010, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. Instead, the law in effect prior to 2010, which generally provides for stepped-up basis in property passing from a decedent, applies.

State death tax credit; deduction for State death taxes paid

State death tax credit under prior law

Before 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate.³⁷ The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which served to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.³⁸ Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or generally 60 days after a decision of a court in which such refund suit has become final.

³⁷ Sec. 2011.

³⁸ Sec. 2058.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA sunset at the end of 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 applies.

Exclusions and deductions

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of \$13,000 (for 2010 and 2011) on transfers of present interests in property to each donee during the taxable year.³⁹ If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$26,000 for 2010 and 2011. The dollar amounts are indexed for inflation.

Transfers to a surviving spouse

In general.—A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses.⁴⁰ Transfers of “qualified terminable interest property” are eligible for the marital deduction. “Qualified terminable interest property” is property: (1) that passes from the decedent; (2) in which the surviving spouse has a “qualifying income interest for life”; and (3) to which an election applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse’s life; and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens.—A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States.⁴¹ A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

For years when the estate tax is in effect, the estate tax is imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of

³⁹ Sec. 2503(b).

⁴⁰ Secs. 2056 & 2523.

⁴¹ Secs. 2056(d)(1) & 2523(i)(1).

the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Conservation easements

For years when an estate tax is in effect, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$500,000.⁴² The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Before 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance of a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As a result of the EGTRRA sunset at the end of 2010, the EGTRRA modifications to expand the availability of qualified conservation contributions do not apply for decedents dying after December 31, 2010.

Provisions affecting small and family-owned businesses and farms

Special-use valuation

For years when an estate tax is in effect, an executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.⁴³ The maximum

⁴² Sec. 2031(c).

⁴³ Sec. 2032A.

reduction in value for such real property was \$1 million for 2009. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years immediately preceding the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to \$675,000.⁴⁴ A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the deduction, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As a result of the EGTRRA sunset at the end of 2010,

⁴⁴ Sec. 2057. The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit effective exemption amount is \$625,000, for a total of \$1.3 million. Because of the coordination between the qualified family-owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds \$1.3 million.

the qualified family-owned business deduction applies to estates of decedents dying after December 31, 2010.

Installment payment of estate tax for closely held businesses

Estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).⁴⁵ An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1.34 million⁴⁶ (as adjusted annually for inflation occurring after 1998; the original amount for 1998 was \$1 million) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1.34 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, indirectly through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a

⁴⁵ Sec. 6166.

⁴⁶ Rev. Proc. 2009-50, I.R.B. 2009-45 (Nov. 9, 2009).

corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As a result of the EGTRRA sunset at the end of 2010, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

Generation-skipping transfer tax rules

In general

For years before and after 2010, a generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a “skip person” (as defined above).⁴⁷ Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.⁴⁸ An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.⁴⁹ Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person

⁴⁷ Sec. 2601.

⁴⁸ Sec. 2611.

⁴⁹ Sec. 2612(c).

has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.⁵⁰ A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).⁵¹ If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the “inclusion ratio.” The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of “generation skipping transfer tax exemption” allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor’s estate tax return.

Modifications to the generation skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are “indirect skips.” An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual’s lifetime, then any unused portion of such individual’s generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property. An individual can elect out of the automatic allocation or may elect to treat a trust as a generation skipping transfer trust attracting the automatic allocation.

⁵⁰ Sec. 2612(a).

⁵¹ Sec. 2612(b).

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a “qualified severance.” A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation skipping transfer tax exemption allocation.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor’s unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

Sunset of EGTRRA modifications to the generation skipping transfer tax rules

The estate and generation skipping transfer taxes are repealed for decedents dying and gifts made in 2010. As a result of the EGTRRA sunset at the end of 2010, the generation skipping transfer tax again will apply after December 31, 2010. However, the EGTRRA modifications to the generation skipping transfer tax rules described above do not apply to generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001 apply.

Explanation of Provision

In general

The provision reinstates the estate and generation skipping transfer taxes effective for decedents dying and transfers made after December 31, 2009. The estate tax applicable exclusion amount is \$5 million under the provision and is indexed for inflation for decedents dying in calendar years after 2011, and the maximum estate tax rate is 35 percent. For gifts made in 2010, the applicable exclusion amount for gift tax purposes is \$1 million, and the gift tax rate is 35 percent. For gifts made after December 31, 2010, the gift tax is reunified with the estate tax, with an applicable exclusion amount of \$5 million and a top estate and gift tax rate of 35 percent.⁵²

The generation skipping transfer tax exemption for decedents dying or gifts made after December 31, 2009, is equal to the applicable exclusion amount for estate tax purposes (e.g., \$5 million for 2010).⁵³ Therefore, up to \$5 million in generation skipping transfer tax exemption may be allocated to a trust created or funded during 2010, depending upon the amount of such exemption used by the taxpayer before 2010. Although the generation skipping transfer tax is applicable in 2010, the generation skipping transfer tax rate for transfers made during 2010 is zero percent. The generation skipping transfer tax rate for transfers made after 2010 is equal to the highest estate and gift tax rate in effect for such year (35 percent for 2011 and 2012).

The provision allows a deduction for certain death taxes paid to any State or the District of Columbia for decedents dying after December 31, 2009.

The provision generally repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the provision, a recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive fair market value basis (i.e., “stepped up” basis) under the basis rules applicable to assets acquired from decedents who died in 2009.⁵⁴

⁵² The provision clarifies current law regarding the computation of estate and gift taxes. Under present law, the gift tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the tax rate schedule in effect in the current year had been in effect on the date of the prior-year gifts. Under the provision, for purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under section 2001(c) at the time of the decedent’s death are used to compute both (1) the gift tax imposed by chapter 12 with respect to such gifts, and (2) the unified credit allowed against such gifts under section 2505 (including in computing the applicable credit amount under section 2505(a)(1) and the sum of amounts allowed as a credit for all preceding periods under section 2505(a)(2)).

⁵³ The \$5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election described below to apply the EGTRRA 2010 estate tax rules and section 1022 basis rules.

⁵⁴ See generally Sec. 1014.

The provision extends the EGTRRA modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the generation skipping transfer tax, described in the present-law section, above.

Election for decedents who die during 2010

In the case of a decedent who dies during 2010, the provision generally allows the executor of such decedent's estate to elect to apply the Internal Revenue Code as if the new estate tax and basis step-up rules described in the preceding section had not been enacted. In other words, instead of applying the above-described new estate tax and basis step-up rules of the provision, the executor may elect to have present law (as enacted under EGTRRA) apply. In general, if such an election is made, the estate would not be subject to estate tax, and the basis of assets acquired from the decedent would be determined under the modified carryover basis rules of section 1022.⁵⁵ This election will have no effect on the continued applicability of the generation skipping transfer tax. In addition, in applying the definition of transferor in section 2652(a)(1), the determination of whether any property is subject to the tax imposed by chapter 11 of the Code is made without regard to an election made under this provision.

The Secretary of the Treasury or his delegate shall determine the time and manner for making the election. The election, once made, is revocable only with the consent of the Secretary or his delegate.

Extension of certain filing deadlines

The provision also provides for the extension of filing deadlines for certain transfer tax returns. Specifically, in the case of a decedent dying after December 31, 2009, and before the date of enactment, the due date shall not be earlier than the date which is nine months after the date of enactment for: (1) filing an estate tax return required under section 6018; (2) making the payment of estate tax under Chapter 11; and (3) making any disclaimer described in section 2518(b) of an interest in property passing by reason the death of such a decedent. In the case of a generation skipping transfer made after December 31, 2009, and before the date of enactment, the due date for filing any return required under section 2662 (including the making of any election required to be made on the return) shall not be earlier than the date which is nine months after the date of enactment.

Portability of unused exemption between spouses

Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion

⁵⁵ Therefore, an heir who acquires an asset from the estate of a decedent who died in 2010 and whose executor elected application of the 2010 EGTRRA rules has a basis in the asset determined under the modified carryover basis rules of section 1022. Such basis is applicable for the determination of any gain or loss on the sale or disposition of the asset in any future year regardless of the status of the sunset provision described below.

amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.⁵⁶

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of \$5 million or the unused exclusion of the last such deceased spouse.⁵⁷ A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own \$5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. The Secretary of the Treasury shall prescribe regulations as may be appropriate and necessary to carry out the rules described in this paragraph.

Example 1.—Assume that Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2.—Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made \$4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is \$3 million (\$2 million for Husband 1 and \$1 million for Husband 2), only Husband 2's \$1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's \$1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

⁵⁶ The provision does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

⁵⁷ The last deceased spouse limitation applies whether or not the last deceased spouse has any unused exclusion or the last deceased spouse's estate makes a timely election.

Example 3.—Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1’s death, Wife’s applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of \$3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is \$4 million (Wife's \$7 million applicable exclusion amount less her \$3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by \$4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

Sunset provision

Under the bill, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions, scheduled to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2010, is extended to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2012. The EGTRRA sunset, as extended by the bill, applies to the amendments made by the provision. Therefore, neither the EGTRRA rules nor the new rules of the provision will apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012.

Effective Date

The estate and generation skipping transfer tax provisions generally are effective for decedents dying, gifts made, and generation skipping transfers made after December 31, 2009. The modifications to the gift tax exemption and rate generally are effective for gifts made after December 31, 2010. The new rules providing for portability of unused exemption between spouses generally are effective for decedents dying and gifts made after December 31, 2010.

TITLE IV – TEMPORARY EXTENSION OF INVESTMENT INCENTIVES

A. Extension of Bonus Depreciation; Temporary 100 Percent Expensing for Certain Business Assets (sec. 401 of the bill and sec. 168(k) of the Code)

Present Law

In general

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property).⁵⁸ The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2009, a taxpayer purchased new depreciable property and placed it in service.⁵⁹ The property's cost is \$1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is \$500. The remaining \$500 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2009. The total depreciation deduction with respect to the property for 2009 is \$600. The remaining \$400 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).⁶⁰ Second, the

⁵⁸ Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

⁵⁹ Assume that the cost of the property is not eligible for expensing under section 179.

⁶⁰ The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

original use⁶¹ of the property must commence with the taxpayer after December 31, 2007.⁶² Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.⁶³ Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

To qualify, property must be acquired (1) after December 31, 2007, and before January 1, 2011, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2011.⁶⁴ With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2011. 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. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2011 (“progress expenditures”) is eligible for the additional first-year depreciation.⁶⁵

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-

⁶¹ The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

⁶² A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(E)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

⁶³ Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

⁶⁴ Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

⁶⁵ For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The \$8,000 increase is not indexed for inflation.

Election to accelerate certain credits in lieu of claiming bonus depreciation

A corporation otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for “eligible qualified property” placed in service after March 31, 2008 and before December 31, 2008.⁶⁶ A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits.⁶⁷ The increases in the allowable credits are treated as refundable. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The research credit or minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation⁶⁸ for certain eligible qualified property that could be claimed absent an election under this provision. Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after March 31, 2008; (2) the taxpayer must purchase the property either (a) after March 31, 2008, and before January 1, 2010, but only if no binding written contract for the

⁶⁶ Sec. 168(k)(4). In the case of an electing corporation that is a partner in a partnership, the corporate partner’s distributive share of partnership items is determined as if section 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property.

⁶⁷ Special rules apply to an applicable partnership.

⁶⁸ For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this provision), and shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

acquisition is in effect before April 1, 2008,⁶⁹ or (b) pursuant to a binding written contract which was entered into after March 31, 2008, and before January 1, 2010;⁷⁰ and (3) the property must be placed in service after March 31, 2008, and before January 1, 2010 (January 1, 2011 for certain longer-lived and transportation property).

The bonus depreciation amount is limited to the lesser of: (1) \$30 million, or (2) six percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006 and minimum tax credits allocable to the adjusted minimum tax imposed for taxable years beginning before January 1, 2006. All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

A corporation may make a separate election to increase the research credit or minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service in 2009 (2010 in the case of certain longer-lived and transportation property). The election applies with respect to extension property, which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the special allowance for certain property acquired during 2009.

A corporation that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable year ending after March 31, 2008, may choose not to make this election for extension property. Further, a corporation that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008, is permitted to make the election for extension property for its first taxable year ending after December 31, 2008, and for each subsequent year. In the case of a taxpayer electing to increase the research or minimum tax credit for both eligible qualified property and extension property, a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group of property.⁷¹

Explanation of Provision

The provision extends and expands the additional first-year depreciation to equal 100 percent of the cost of qualified property placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived and transportation property), and provides for a 50 percent first-year additional depreciation deduction for qualified property placed in service after December 31, 2011 and before January 1, 2013 (after December 31, 2012 and before January 1, 2014 for certain longer-lived and transportation property). Rules similar to those in section 168(k)(2)(A)(ii) and (iii), which provide that qualified property does not include property acquired pursuant to a written binding contract that was in effect prior to January 1,

⁶⁹ In the case of passenger aircraft, the written binding contract limitation does not apply.

⁷⁰ Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

⁷¹ In computing the maximum amount, the maximum increase amount for extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property.

2008, apply for purposes of determining whether property is eligible for the temporary 100 percent additional first-year depreciation deduction. Thus under the provision, property acquired pursuant to a written binding contract entered into after December 31, 2007 is qualified property for purposes of the 100 percent additional first-year depreciation deduction assuming all other requirements of section 168(k)(2) are met.

The provision generally permits a corporation to increase the minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service after December 31, 2010 and before January 1, 2013 (January 1, 2014 in the case of certain longer-lived and transportation property).⁷² The provision applies with respect to round 2 extension property, which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the additional first-year depreciation deduction for certain property placed in service after December 31, 2010.⁷³

Under the provision, a taxpayer that has made an election to increase the research credit or minimum tax credit limitation for eligible qualified property for its first taxable year ending after March 31, 2008 or for extension property may choose not to make this election for round 2 extension property. Further, the provision allows a taxpayer that has not made an election for eligible qualified property for its first taxable year ending after March 31, 2008 or for extension property, to make the election for round 2 extension property for its first taxable year ending after December 31, 2010, and for each subsequent year. In the case of a taxpayer electing to increase the research or minimum tax credit for eligible qualified property and extension property and the minimum tax credit for round 2 extension property a separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to each group of property.⁷⁴

Effective Date

The provision generally applies to property placed in service by the taxpayer after December 31, 2010, in taxable years ending after such date. The provision expanding the additional first-year depreciation deduction to 100 percent of the basis of qualified property

⁷² A taxpayer does not compute a bonus depreciation amount under section 168(k)(4)(C) for any bonus depreciation allowable with respect to property placed in service during 2010. For example, assume in its taxable year beginning October 1, 2010 and ending September 30, 2011, a corporation places into service qualified property with a total cost of \$1,000,000, of which \$250,000 was placed in service before December 31, 2010. The corporation computes its bonus depreciation amount under section 168(k)(4)(C) taking into account only the bonus depreciation computed with respect to the \$750,000 of property placed in service after December 31, 2010.

⁷³ An election under new section 168(k)(4)(I) with respect to round 2 extension property is binding for any property that is eligible qualified property solely by reason of the amendments made by section 401(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (and the application of such extension to this paragraph pursuant to the amendment made by section 401(c)(1) of such Act), even if such property is placed in service in 2012.

⁷⁴ In computing the maximum amount, the maximum increase amount for extension property or for round 2 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to extension property or round 2 extension property, respectively.

applies to property placed in service by the taxpayer after September 8, 2010, in taxable years ending after such date.

**B. Temporary Extension of Increased Small Business Expensing
(sec. 402 of the bill and sec. 179 of the Code)**

Present Law

Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions.⁷⁵ For taxable years beginning in 2010 and 2011, the maximum amount that a taxpayer may expense is \$500,000 of the cost of qualifying property placed in service for the taxable year.⁷⁶ The \$500,000 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 \$2,000,000.⁷⁷ Off-the-shelf computer software placed in service in taxable years beginning before 2012 is treated as qualifying property.

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 generally may be carried forward to succeeding taxable years (subject to similar limitations).⁷⁸ No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.⁷⁹

For taxable years beginning in 2012 and thereafter, 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. In general, qualifying

⁷⁵ 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)). In addition, section 179(e) provides for an enhanced section 179 deduction for qualified disaster assistance property.

⁷⁶ The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to \$250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See section 179(f)(2).

⁷⁷ The temporary \$500,000 and \$2,000,000 amounts were enacted in the Small Business Jobs Act of 2010, Pub. L. No. 111-240.

⁷⁸ Special rules apply to limit the carryover of unused section 179 deductions attributable to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See section 179(f)(4).

⁷⁹ Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software).

Explanation of Provision

Under the provision, for taxable years beginning in 2012, the maximum amount a taxpayer may expense is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. The \$125,000 and \$500,000 amounts are indexed for inflation.

In addition, the provision extends the treatment of off-the-shelf computer software as qualifying property,⁸⁰ as well as the provision permitting a taxpayer to amend or irrevocably revoke an election for a taxable year under section 179 without the consent of the Commissioner for one year (through 2012).

For taxable years beginning in 2013, and thereafter, the maximum amount a taxpayer may expense is \$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.

Effective Date

The provision is effective for taxable years beginning after December 31, 2011.

⁸⁰ The temporary extension of the definition of qualifying property to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property is not extended.

TITLE VI – TEMPORARY EMPLOYEE PAYROLL TAX CUT

A. Payroll Tax Cut (sec. 601 of the bill)

Present Law

Federal Insurance Contributions Act (“FICA”) tax

The FICA tax applies to employers based on the amount of covered wages paid to an employee during the year.⁸¹ Generally, covered wages means all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash.⁸² Certain exceptions from covered wages are also provided. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance (“OASDI”) tax equal to 6.2 percent of covered wages up to the taxable wage base (\$106,800 in 2010); and (2) the Medicare hospital insurance (“HI”) tax amount equal to 1.45 percent of covered wages.

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (the “employee portion”).⁸³ The employee portion generally must be withheld and remitted to the Federal government by the employer.

Self-Employment Contributions Act (“SECA”) tax

As a parallel to FICA taxes, the SECA tax applies to the self-employment income of self-employed individuals.⁸⁴ The rate of the OASDI portion of SECA taxes is 12.4 percent, which is equal to the combined employee and employer OASDI FICA tax rates, and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is 2.9 percent, the same as the combined employer and employee HI rates under the FICA tax, and there is no cap on the amount of self-employment income to which the rate applies.⁸⁵

An individual may deduct, in determining net earnings from self-employment under the SECA tax, the amount of the net earnings from self-employment (determined without regard to this deduction) for the taxable year multiplied by one half of the combined OASDI and HI rates.⁸⁶

⁸¹ Sec. 3111.

⁸² Sec. 3121.

⁸³ Sec. 3101. For taxable years beginning after 2012, an additional HI tax applies.

⁸⁴ Sec. 1401.

⁸⁵ For taxable years beginning after 2012, an additional HI tax applies.

⁸⁶ Sec. 1402(a)(12).

Additionally, a deduction, for purposes of computing the income tax of an individual, is allowed for one half of the amount of the SECA tax imposed on the individual's self-employment income for the taxable year.⁸⁷

Railroad retirement tax

The Railroad Retirement System has two main components. Tier I of the system is financed by taxes on employers and employees equal to the Social Security payroll tax and provides qualified railroad retirees (and their qualified spouses, dependents, widows, or widowers) with benefits that are roughly equal to Social Security. Covered railroad workers and their employers pay the Tier I tax instead of the Social Security payroll tax, and most railroad retirees collect Tier I benefits instead of Social Security. Tier II of the system replicates a private pension plan, with employers and employees contributing a certain percentage of pay toward the system to finance defined benefits to eligible railroad retirees (and qualified spouses, dependents, widows, or widowers) upon retirement; however, the Federal Government collects the Tier II payroll contribution and pays out the benefits.

Explanation of Provision

The provision reduces the employee OASDI tax rate under the FICA tax by two percentage points to 4.2 percent for one year (2011). Similarly, the provision reduces the OASDI tax rate under the SECA tax by two percentage points to 10.4 percent for taxable years of individuals that begin in 2011. A similar reduction applies to the railroad retirement tax.

The provision provides rules for coordination with deductions for employment taxes. The rate reduction is not taken into account in determining the SECA tax deduction allowed for determining the amount of the net earnings from self-employment for the taxable year. Thus, the deduction for 2011 remains at 7.65 percent of self-employment income (determined without regard to the deduction).

The income tax deduction allowed under section 164(f) for taxable years beginning in 2011 is computed at the rate of 59.6 percent of the OASDI tax paid, plus one half of the HI tax paid.⁸⁸

The provision provides that the Treasury Secretary is to notify employers of the payroll tax cut.

The Federal Old-Age and Survivors Trust Fund, the Federal Disability Insurance Trust Fund, and the Social Security Equivalent Benefit Account established under the Railroad

⁸⁷ Sec. 164(f).

⁸⁸ This percentage replaces the rate of one half (50 percent) allowed under present law for this portion of the deduction. The new percentage is necessary to continue to allow the self-employed taxpayer to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate remains at 6.2 percent, while the employee portion falls to 4.2 percent. Thus, the employer share of total OASDI taxes is 6.2 divided by 10.4, or 59.6 percent of the OASDI portion of SECA taxes.

Retirement Act of 1974⁸⁹ will receive transfers from the General Fund of the United States Treasury equal to any reduction in payroll taxes attributable to this provision. The amounts will be transferred from the General Fund at such times and in such a manner as to replicate to the extent possible the transfers which would have occurred to the Trust Funds or Benefit Account had the provision not been enacted.

For purposes of applying any provision of Federal law other than the provisions of the Internal Revenue Code of 1986, the rate of tax in effect under section 3101(a) is determined without regard to the reduction in that rate under this provision.

Effective Date

The provision is effective for remuneration received during 2011 and for self-employment income for taxable years beginning in 2011.

⁸⁹ 45 U.S.C. 231n-1(a).

TITLE VII – TEMPORARY EXTENSION OF CERTAIN EXPIRING PROVISIONS

A. Energy

1. Incentives for biodiesel and renewable diesel (sec. 701 of the bill and secs. 40A, 6426 and 6427 of the Code)

Present Law

Biodiesel

The Code provides an income tax credit for biodiesel fuels (the “biodiesel fuels credit”).⁹⁰ The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2009.

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

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

Biodiesel mixture credit

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

⁹⁰ Sec. 40A.

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture.⁹¹ Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

Biodiesel credit (B-100)

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

Small agri-biodiesel producer credit

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is 10-cents-per-gallon for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.⁹² The credit is \$1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.⁹³

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

⁹¹ Notice 2005-62, I.R.B. 2005-35, 443 (2005). "A biodiesel mixture is a mixture of biodiesel and diesel fuel containing at least 0.1 percent (by volume) of diesel fuel. Thus, for example, a mixture of 999 gallons of biodiesel and 1 gallon of diesel fuel is a biodiesel mixture." Ibid.

⁹² Sec. 6426(c).

⁹³ Sec. 6426(c)(4).

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.⁹⁴ The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels. To the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2009.

Renewable diesel

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

For purposes of the Code, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.⁹⁵ The incentive for renewable diesel is \$1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2009.

Explanation of Provision

The provision extends the income tax credit, excise tax credit and payment provisions for biodiesel and renewable diesel for two additional years (through December 31, 2011).

In light of the retroactive nature of the provision, the provision creates a special rule to address claims regarding excise credits and claims for payment associated with periods occurring during 2010. In particular the provision directs the Secretary to issue guidance within 30 days of the date of enactment. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2010. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary of the Treasury not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the

⁹⁴ Sec. 6427(e).

⁹⁵ Secs. 40A(f), 6426(c), and 6427(e).

filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under section 6621 of such Code.

Effective Date

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

2. Credit for refined coal facilities (sec. 702 of the bill and sec. 45 of the Code)

Present Law

In general

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

Refined coal used to produce steam

An income tax credit is allowed for the production at qualified facilities of certain refined coal sold to an unrelated person for use to produce steam. The amount of the refined coal credit is \$4.375 per ton (adjusted for inflation using 1992 as the base year; \$6.27 for 2010). A taxpayer may generally claim the credit during the 10-year period commencing with the date the qualified facility is placed in service.

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

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

The credit is a component of the general business credit,⁹⁶ allowing excess credits to be carried back one year and forward up to 20 years. The credit is also subject to the alternative minimum tax.

⁹⁶ Sec. 38(b)(8).

Facilities placed in service after 2008 that make refined coal used to produce steam

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

Refined coal that is steel industry fuel

Each barrel-of-oil equivalent (defined as 5.8 million British thermal units) of steel industry fuel produced at a qualified facility during the credit period receives a \$2 credit (adjusted for inflation using 1992 as the base year; \$2.87 for 2010). A qualified facility is any facility capable of producing steel industry fuel (or any modification to a facility making it so capable) that is placed in service before January 1, 2010. For facilities capable of producing steel industry fuel on or before October 1, 2008, the credit is available for fuel produced and sold on or after such date and before January 1, 2010. For facilities placed in service or modified to produce steel industry fuel after October 1, 2008, the credit period begins on the placed-in-service or modification date and ends one year after such date or December 31, 2009, whichever is later.

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

Explanation of Provision

The provision extends for two years (through December 31, 2011) the placed-in-service period for new refined coal facilities other than refined coal facilities that produce steel industry fuel.

Effective Date

The modifications to the placed-in-service period are effective on the date of enactment.

3. New energy efficient home credit (sec. 703 of the bill and sec. 45L of the Code)

Present Law

The Code provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets

the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

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

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

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

Explanation of Provision

The provision extends the credit to homes that are purchased prior to January 1, 2012.

Effective Date

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

4. Excise tax credits and outlay payments for alternative fuel and alternative fuel mixtures (sec. 704 of the bill and secs. 6426 and 6427(e) of the Code)

Present Law

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

For coal-to-liquids produced after September 30, 2009 through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that

separates and sequesters 50 percent of such facility's total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against section 4041 liability, and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents⁹⁷ of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

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

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

Explanation of Provision

The provision extends the alternative fuel credit, alternative fuel mixture credit, and related payment provisions, for two additional years (through December 31, 2011). For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, the provision excludes fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

In light of the retroactive nature of the provision, the provision creates a special rule to address claims regarding excise credits and claims for payment associated with periods occurring during 2010. In particular the provision directs the Secretary to issue guidance within 30 days of the date of enactment. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2010. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary of the Treasury not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the

⁹⁷ "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under section 6621 of such Code.

Effective Date

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

5. Special rule for sales or dispositions to implement FERC or State electric restructuring policy for qualified electric utilities (sec. 705 of the bill and sec. 451(i) of the Code)

Present Law

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

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period⁹⁸ (the "reinvestment property").⁹⁹ If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2010. A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both (1) a transmitting utility (as defined in the Federal Power Act)¹⁰⁰ with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act).¹⁰¹

⁹⁸ The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

⁹⁹ Sec. 451(i).

¹⁰⁰ Sec. 3(23), 16 U.S.C. 796, defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or Federal power marketing agency which owns or operates electric power transmission facilities which are used for the sale of electric energy at wholesale.

¹⁰¹ Sec. 3(22), 16 U.S.C. 796, defines "electric utility" as any person or State agency (including any municipality) which sells electric energy; such term includes the Tennessee Valley Authority, but does not include any Federal power marketing agency.

In general, an independent transmission company is defined as: (1) an independent transmission provider¹⁰² approved by the Federal Energy Regulatory Commission (“FERC”); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a “market participant” and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

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

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

Explanation of Provision

The provision extends the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility that occur prior to January 1, 2012.

Effective Date

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

6. Suspension of limitation on percentage depletion for oil and gas from marginal wells (sec. 706 of the bill and sec. 613A of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.¹⁰³ Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the

¹⁰² For example, a regional transmission organization, an independent system operator, or an independent transmission company.

¹⁰³ Secs. 611-613.

taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.¹⁰⁴ Generally, under the percentage depletion method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year.¹⁰⁵ The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation").¹⁰⁶ The 100-percent net-income limitation for marginal production has been suspended for taxable years beginning before January 1, 2010.

Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).¹⁰⁷

Explanation of Provision

The provision extends the suspension of the 100-percent net-income limitation for marginal production for two years (to apply to tax years beginning before January 1, 2012).

Effective Date

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

7. Extension of grants for specified energy property in lieu of tax credits (sec. 707 of the bill)

Present Law

Renewable electricity production credit

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities (the "renewable electricity production credit").¹⁰⁸ Qualified

¹⁰⁴ Sec. 613A.

¹⁰⁵ Sec. 613A(c).

¹⁰⁶ Sec. 613(a).

¹⁰⁷ The American Petroleum Institute gravity, or API gravity, is a measure of how heavy or light a petroleum liquid is compared to water.

¹⁰⁸ Sec. 45. In addition to the renewable electricity production credit, section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

| Summary of Credit for Electricity Produced from Certain Renewable Resources | | |
|--|---|-------------------------------|
| Eligible electricity production activity (sec. 45) | Credit amount for 2010¹ (cents per kilowatt-hour) | Expiration² |
| Wind | 2.2 | December 31, 2012 |
| Closed-loop biomass | 2.2 | December 31, 2013 |
| Open-loop biomass (including agricultural livestock waste nutrient facilities) | 1.1 | December 31, 2013 |
| Geothermal | 2.2 | December 31, 2013 |
| Solar (pre-2006 facilities only) | 2.2 | December 31, 2005 |
| Small irrigation power | 1.1 | December 31, 2013 |
| Municipal solid waste (including landfill gas facilities and trash combustion facilities) | 1.1 | December 31, 2013 |
| Qualified hydropower | 1.1 | December 31, 2013 |
| Marine and hydrokinetic | 1.1 | December 31, 2013 |

¹ In general, the credit is available for electricity produced during the first 10 years after a facility has been placed in service.

² Expires for property placed in service after this date.

Energy credit

An income tax credit is also allowed for certain energy property placed in service. Qualifying property includes certain fuel cell property, solar property, geothermal power

production property, small wind energy property, combined heat and power system property, and geothermal heat pump property.¹⁰⁹

| Summary of Energy Investment Tax Credit | | | | |
|--|--|-----------------------------------|-----------------------------------|-------------------|
| | | Credit rate | Maximum credit | Expiration |
| Energy credit (sec. 48) | Equipment to produce a geothermal deposit | 10% | None | None |
| | Equipment to use ground or ground water for heating or cooling | 10% | None | December 31, 2016 |
| | Microturbine property (< 2 Mw electrical generation power plants of >26% efficiency) | 10% | \$200 per Kw of capacity | December 31, 2016 |
| | Combined heat and power property (simultaneous production of electrical/mechanical power and useful heat > 60% efficiency) | 10% | None | December 31, 2016 |
| | Solar electric or solar hot water property | 30% (10% after December 31, 2016) | None | None |
| | Fuel cell property (generates electricity through electrochemical process) | 30% | \$1,500 for each ½ Kw of capacity | December 31, 2016 |
| | Small (<100 Kw capacity) wind electrical generation property | 30% | None | December 31, 2016 |

¹⁰⁹ Sec. 48.

Election to claim energy credit in lieu of renewable electricity production credit

A taxpayer may make an irrevocable election to have certain property which is part of a qualified renewable electricity production facility be treated as energy property eligible for a 30 percent investment credit under section 48. For this purpose, qualified facilities are facilities otherwise eligible for the renewable electricity production credit with respect to which no credit under section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the renewable electricity production credit. The eligible basis for the investment credit for taxpayers making this election is the basis of the depreciable (or amortizable) property that would comprise a facility capable of generating electricity eligible for the renewable electricity production credit.

Grants in lieu of credits

The Secretary of the Treasury is authorized to provide a grant to each person who places in service depreciable property that is either (1) part of a qualified renewable electricity production facility or (2) qualifying property otherwise eligible for the energy credit. In general, the grant amount is 30 percent of the basis of the qualified property. For qualified microturbine, combined heat and power system, and geothermal heat pump property, the amount is 10 percent of the basis of the property. Otherwise eligible property must be placed in service in calendar years 2009 or 2010, or its construction must begin during that period and must be completed prior to 2013 (in the case of wind facility property), 2014 (in the case of other renewable power facility property eligible for credit under section 45), or 2017 (in the case of any specified energy property described in section 48).

The grant provision mimics the operation of the energy credit. For example, the amount of the grant is not includable in gross income. However, the basis of the property is reduced by 50 percent of the amount of the grant. In addition, some or all of each grant is subject to recapture if the grant-eligible property is disposed of by the grant recipient within five years of being placed in service.

Under the provision, if a grant is paid, no renewable electricity credit or energy credit may be claimed with respect to the grant-eligible property. In general, tax-exempt entities are not eligible to receive a grant. No grant may be made unless the application for the grant has been received before October 1, 2011.

Description of Proposal

The proposal extends the Secretary's authority to provide grants in lieu of credits for one year (through 2011). Otherwise eligible property must thus be placed in service in calendar years 2009, 2010, or 2011, or its construction must begin during that period and must be completed prior to 2013 (in the case of wind facility property), 2014 (in the case of other renewable power facility property eligible for credit under section 45), or 2017 (in the case of any specified energy property described in section 48).

Effective Date

The proposal is effective on the date of enactment.

8. Extension of provisions related to alcohol used as fuel (sec. 708 of the bill and secs. 40, 6426, 6427(e) of the Code)

Present Law

Sections 40, 6426 and 6427(e) provide per-gallon tax incentives for the sale, use and production of alcohol fuel and alcohol fuel mixtures. The incentives for alcohol generally do not apply after December 31, 2010. For cellulosic biofuel (discussed infra), the incentive is unavailable after December 31, 2012.

“Alcohol” includes methanol and ethanol, and the alcohol gallon equivalent of ethyl tertiary butyl ether, or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal, or any alcohol with a proof of less than 150 (190 proof for purposes of the credit taken under 6426 or payment under section 6427). Denaturants (additives that make the alcohol unfit for human consumption) are disregarded for purposes of determining proof. However, denaturants are taken into account in determining the volume of alcohol eligible for the per-gallon incentive. In calculating alcohol volume, denaturants cannot exceed two percent of volume.

The section 40 alcohol fuels credit is an income tax credit comprised of four components: (1) the alcohol mixture credit, (2) the alcohol credit, (3) the small ethanol producer credit, and (4) the cellulosic biofuel producer credit. Sections 6426 and 6427(e) pertain to alcohol fuel mixtures only.

Alcohol mixture credits and payments

The alcohol fuel mixture credit may be taken as part of the section 40 income tax credit, the section 6426 excise tax credit, or as a payment under section 6427. For section 40, an alcohol fuel mixture is a mixture of alcohol and gasoline or alcohol and a special fuel. Since the excise tax credit is taken against the liability for taxable fuels (gasoline, kerosene, or diesel), for purposes of the excise tax payments and credits, an alcohol fuel mixture is a mixture of alcohol and a taxable fuel.

The fuel must be either sold for use as a fuel to another person or used as fuel in the mixture producer’s trade or business. The addition of denaturants does not constitute production of a mixture. The credit is allowed only for the gallons of alcohol used to produce the mixture. For alcohol that is ethanol, the amount of the incentive is 45 cents per gallon. For other alcohol, the incentive is generally 60 cents per gallon.

The alcohol mixture credit is most often taken as an excise tax credit or payment. Persons who blend alcohol with gasoline, diesel fuel, or kerosene to produce an alcohol fuel mixture must pay tax on the volume of alcohol in the mixture when the mixture is sold or removed. The alcohol fuel mixture credit must first be taken to reduce excise tax liability for gasoline, diesel fuel or kerosene. Any excess credit may be taken as a payment or income tax credit.

Alcohol credit (straight or “neat” alcohol)

The second component of the section 40 income tax credit is the alcohol credit. The credit is available for alcohol (not in a mixture) that is either (1) used as a fuel in the taxpayer’s trade or business, or (2) sold at retail and placed in the fuel tank of the retail buyer. The credit cannot be claimed for alcohol bought at retail, even if the buyer uses it as a fuel in a trade or business. This credit is not available as an excise tax credit or payment.

Small ethanol producer credit

The third component of the section 40 income tax credit is the small ethanol producer credit. It is in addition to the credits described above and is an extra 10 cents per gallon available for up to 15 million gallons of qualified ethanol fuel production for any tax year. The 15 million gallon limitation is waived for ethanol that is cellulosic ethanol. The credit is available to eligible small ethanol producers, defined as producers who have an annual productive capacity of not more than 60 million gallons of any type of alcohol. Qualified ethanol fuel production is ethanol produced and sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person’s trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person. Qualified ethanol fuel production also includes use or sale by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons. The small ethanol producer credit is not available as an excise tax credit or payment.

Cellulosic biofuel producer credit

The cellulosic biofuel producer credit is a nonrefundable income tax credit for each gallon of qualified cellulosic fuel production of the producer for the taxable year. The amount of the credit per gallon is \$1.01, except in the case of cellulosic biofuel that is alcohol. In the case of cellulosic biofuel that is alcohol, the \$1.01 credit amount is reduced by (1) the credit amount applicable for such alcohol under the alcohol mixture credit as in effect at the time cellulosic biofuel is produced and (2) in the case of cellulosic biofuel that is also ethanol, the credit amount for small ethanol producers as in effect at the time the cellulosic biofuel fuel is produced. The reduction applies regardless of whether the producer claims the alcohol mixture credit or small ethanol producer credit with respect to the cellulosic alcohol. When the alcohol mixture credit and small ethanol producer credit expire after December 31, 2010, cellulosic biofuel that is alcohol is entitled to the \$1.01 without reduction.

Duties on ethanol

Heading 9901.00.50 of the Harmonized Tariff Schedule of the United States imposes a cumulative general duty of 14.27 cents per liter (approximately 54 cents per gallon) on imports of ethyl alcohol, and any mixture containing ethyl alcohol, if used as a fuel or in producing a mixture to be used as a fuel, that are entered into the United States prior to January 1, 2011. Heading 9901.00.52 of the Harmonized Tariff Schedule of the United States imposes a general

duty of 5.99 cents per liter on imports of ethyl tertiary-butyl ether, and any mixture containing ethyl tertiary-butyl ether, that are entered into the United States prior to January 1, 2011.

Explanation of Provision

Extension of income tax credit

The provision extends the present-law income tax credit for alcohol fuels (other than the cellulosic biofuel producer credit) an additional year, through December 31, 2011.

Extension of excise tax credit and outlay payment provisions for alcohol used as a fuel

The provision extends the present-law excise tax credit and outlay payments for alcohol fuel mixtures for an additional year, through December 31, 2011.

Extension of additional duties on ethanol

The provision extends the present-law duties on ethanol and ethyl tertiary butyl ether for an additional year, through December 31, 2011.

Effective Date

The extension of the income tax credit is effective for periods after December 31, 2010. The extension of excise tax credit for alcohol fuel mixtures applies to periods after December 31, 2010. The extension of the payment provisions for alcohol fuel mixtures apply to sales and uses after December 31, 2010. The extension of additional duties on ethanol takes effect on January 1, 2011.

9. Energy efficient appliance credit (sec. 709 of the bill and sec. 45M of the Code)

Present Law

In general

A credit is allowed for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators. The credit is part of the general business credit.

The credits are as follows:

Dishwashers

\$45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle, and

\$75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes washers

\$75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed a 8.0 water consumption factor, and

\$125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,

\$150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor, and

\$250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor.

Refrigerators

\$50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

\$75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but not more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

\$100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009, or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards, and

\$200 in the case of a refrigerator manufactured in calendar year 2008, 2009, or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards.

Definitions

A dishwasher is any residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

The term “modified energy factor” means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.

The term “gallons per cycle” means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term “water consumption factor” means, with respect to a clothes washer, the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

Other rules

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the two prior calendar years for each category of appliance. The aggregate credit amount allowed with respect to a taxpayer for all taxable years beginning after December 31, 2007 may not exceed \$75 million, with the exception that the \$200 refrigerator credit and the \$250 clothes washer credit are not limited. Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

Explanation of Provision

The provision extends the credit for one year, for appliances manufactured in 2011, and changes the aggregate credit limitation to permit up to \$25 million in credits to be claimed per manufacturer for appliances manufactured in 2011. Additionally, the provision changes the two percent gross receipts limitation on the credit to four percent. The credit modifies the standards and credit amounts as follows:

Dishwashers

\$25 in the case of a dishwasher which is manufactured in calendar year 2011 and which uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings),

\$50 in the case of a dishwasher which is manufactured in calendar year 2011 and which uses no more than 295 kilowatt hours per year and 4.25 gallons per cycle (4.75 gallons per cycle for dishwashers designed for greater than 12 place settings), and

\$75 in the case of a dishwasher which is manufactured in calendar year 2011 and which uses no more than 280 kilowatt hours per year and 4 gallons per cycle (4.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes washers

\$175 in the case of a top-loading clothes washer manufactured in calendar year 2011 which meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor, and

\$225 in the case of a clothes washer manufactured in calendar year 2011 which (1) is a top-loading clothes washer and which meets or exceeds a 2.4 modified energy factor and does not exceed a 4.2 water consumption factor, or (2) is a front-loading clothes washer and which meets or exceeds a 2.8 modified energy factor and does not exceed a 3.5 water consumption factor.

Refrigerators

\$150 in the case of a refrigerator manufactured in calendar year 2011 which consumes at least 30 percent less energy than the 2001 energy conservation standards, and

\$200 in the case of a refrigerator manufactured in calendar year 2011 which consumes at least 35 percent less energy than the 2001 energy conservation standards.

Effective Date

The provision applies to appliances produced after December 31, 2010. The provision related to the gross receipts limitation applies to taxable years beginning after December 31, 2010.

10. Credit for nonbusiness energy property (sec. 710 of the bill and sec. 25C of the Code)

Present Law

In general

Section 25C provides a 30-percent credit for the purchase of qualified energy efficiency improvements to the envelope of existing homes. Additionally, section 25C provides a 30 percent credit for the purchase of (1) qualified natural gas, propane, or oil furnace or hot water boilers, (2) qualified energy efficient property, and (3) advanced main air circulating fans.

The credit applies to expenditures made after December 31, 2008, for property placed in service after December 31, 2008, and prior to January 1, 2011.¹¹⁰ The aggregate amount of the credit allowed for a taxpayer for taxable years beginning in 2009 and 2010 is \$1,500.

Building envelope improvements

A qualified energy efficiency improvement is any energy efficiency building envelope component (1) that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code¹¹¹ as supplemented and as in effect on August 8, 2005 (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

¹¹⁰ With the exception of biomass fuel property, property placed in service after December 31, 2008 and prior to February 17, 2009 qualifies for the new 30 percent credit rate (and \$1,500 aggregate cap) if it met the efficiency standards of prior law for property placed in service during 2009. Biomass fuel property placed in service at any point in 2009 is governed by the new efficiency standard.

¹¹¹ This reference to the 2000 International Energy Conservation Code is superseded by the additional requirements described in the paragraph below regarding building envelope components.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling and which meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors provided such component has a U-factor and a seasonal heat gain coefficient (“SHGC”) of 0.3 or less; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

Other eligible property

Qualified natural gas, propane, or oil furnace or hot water boilers

A qualified natural gas, propane, or oil hot water boiler is a natural gas, propane, or oil hot water boiler with an annual fuel utilization efficiency rate of at least 90. A qualified natural gas or propane furnace is a natural gas or propane furnace with an annual fuel utilization efficiency rate of at least 95. A qualified oil furnace is an oil furnace with an annual fuel utilization efficiency rate of at least 90.

Qualified energy-efficient property

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009,¹¹² (3) a central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009,¹¹³ (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent as measured using a lower heating value. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers.

¹¹² These standards are a seasonal energy efficiency ratio (“SEER”) greater than or equal to 15, an energy efficiency ratio (“EER”) greater than or equal to 12.5, and heating seasonal performance factor (“HSPF”) greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

¹¹³ These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

Advanced main air circulating fan

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

Additional rules

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

Explanation of Provision

The provision extends the credits for one year but utilizes the credit structure and credit rates that existed prior to the enactment of the American Recovery and Reinvestment Act of 2009. The provision reinstates the rule that expenditures made from subsidized energy financing are not qualifying expenditures. Additionally, certain efficiency standards that were weakened in the American Recovery and Reinvestment Act are restored to their prior levels. Lastly, the provision provides that windows, skylights and doors that meet the Energy Star standards are qualified improvements.

The following describes the operation of the credit under the provision:

Section 25C provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes. A qualified energy efficiency improvement is any energy efficiency building envelope component (1) that meets or exceeds the prescriptive criteria for such a component established by the 2009 International Energy Conservation Code as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009) (or, in the case of windows, skylights and doors, and metal roofs with appropriate pigmented coatings or asphalt roofs with appropriate cooling granules, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling and which meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009 (February 17, 2009); (2) exterior windows (including skylights) and doors; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

Additionally, section 25C provides specified credits for the purchase of specific energy efficient property originally placed in service by the taxpayer during the taxable year. The allowable credit for the purchase of certain property is (1) \$50 for each advanced main air circulating fan, (2) \$150 for each qualified natural gas, propane, or oil furnace or hot water boiler, and (3) \$300 for each item of qualified energy efficient property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an annual fuel utilization efficiency rate of at least 95.

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009,¹¹⁴ (3) a central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2009,¹¹⁵ (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers.

Under section 25C, the maximum credit for a taxpayer for all taxable years is \$500, and no more than \$200 of such credit may be attributable to expenditures on windows.

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

¹¹⁴ These standards are a seasonal energy efficiency ratio ("SEER") greater than or equal to 15, an energy efficiency ratio ("EER") greater than or equal to 12.5, and heating seasonal performance factor ("HSPF") greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

¹¹⁵ These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, expenditures which are made from subsidized energy financing are not taken into account. The term "subsidized energy financing" means financing provided under a Federal, State, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

Effective Date

The provision applies to property placed in service after December 31, 2010.

11. Alternative fuel vehicle refueling property (sec. 711 of the bill and sec. 30C of the Code)

Present Law

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.¹¹⁶ The credit may not exceed \$30,000 per taxable year per location, in the case of qualified refueling property used in a trade or business and \$1,000 per taxable year per location, in the case of qualified refueling property installed on property which is used as a principal residence.

For property placed in service in 2009 or 2010, the maximum credit available for business property is increased to \$200,000 for qualified hydrogen refueling property and to \$50,000 for other qualified refueling property. For nonbusiness property, the maximum credit is increased to \$2,000 for refueling property other than hydrogen refueling property. In addition, during these years, the credit rate is increased from 30 percent to 50 percent for refueling property other than hydrogen refueling property.

Qualified refueling property is property (not including a building or its structural components) for the storage or dispensing of a clean-burning fuel or electricity into the fuel tank or battery of a motor vehicle propelled by such fuel or electricity, but only if the storage or dispensing of the fuel or electricity is at the point of delivery into the fuel tank or battery of the motor vehicle. The original use of such property must begin with the taxpayer.

Clean-burning fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen. In addition, any mixture of biodiesel and diesel fuel, determined without regard to any use of kerosene and containing at least 20 percent biodiesel, qualifies as a clean fuel.

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for one year and forward for 20 years. Credits for residential qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative

¹¹⁶ Sec. 30C.

minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

A taxpayer's basis in qualified refueling property is reduced by the amount of the credit. In addition, no credit is available for property used outside the United States or for which an election to expense has been made under section 179.

The credit is available for property placed in service after December 31, 2005, and (except in the case of hydrogen refueling property) before January 1, 2011. In the case of hydrogen refueling property, the property must be placed in service before January 1, 2015.

Explanation of Provision

The provision extends through 2011 the 30-percent credit for alternative fuel refueling property (other than hydrogen refueling property, the credit for which continues under present law through 2014), subject to the pre-2009 maximum credit amounts.

Effective Date

The provision is effective for property placed in service after December 31, 2010.

B. Individual Tax Relief

1. Deduction for certain expenses of elementary and secondary school teachers (sec. 721 of the bill and sec. 62 of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible. However, unreimbursed employee business expenses generally are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. With the exception of taxable years beginning in 2010, an individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of a threshold amount. In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2010, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.¹¹⁷ To be eligible for this deduction, the expenses must be otherwise deductible under section 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade twelve teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2009.

Explanation of Provision

The provision extends the deduction for eligible educator expenses for two years so that it is available for taxable years beginning before January 1, 2012.

¹¹⁷ Sec. 62(a)(2)(D).

Effective Date

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

2. Deduction of State and local sales taxes (sec. 722 of the bill and sec. 164 of the Code)

Present Law

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

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

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

Explanation of Provision

The provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for two years (through December 31, 2011).

Effective Date

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

3. Contributions of capital gain real property made for conservation purposes (sec. 723 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.¹¹⁸

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, (i.e., taxpayer's adjusted gross income computed without regard to any net operating loss carryback). The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions by an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

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

¹¹⁸ Secs. 170, 2055, and 2522, respectively.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.¹¹⁹ A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules as other charitable contributions of capital gain property.

¹¹⁹ Secs. 170(f)(3)(B)(iii) and 170(h).

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

In general

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,¹²⁰ the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of \$100 makes a qualified conservation contribution of property with a fair market value of \$80 and makes other charitable contributions subject to the 50-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent of the \$100 contribution base) and is allowed to carry over the excess \$10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire \$80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the \$50 deduction for non-conservation contributions, an additional \$50 for the qualified conservation contribution is allowed and \$30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable

¹²⁰ Sec. 170(b)(1)(E).

charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.¹²¹

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

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

Termination

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2009.¹²²

Explanation of Provision

The Act extends the special rule regarding contributions of capital gain real property for conservation purposes for two years for contributions made in taxable years beginning before January 1, 2012.

Effective Date

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

4. Above-the-line deduction for qualified tuition and related expenses (sec. 724 of the bill and sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.¹²³ The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the

¹²¹ Sec. 170(b)(2)(B).

¹²² Secs. 170(b)(1)(E)(vi) and 170(b)(2)(B)(iii).

¹²³ Sec. 222.

taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.¹²⁴ The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2009.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,¹²⁵ and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.¹²⁶ Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

Explanation of Provision

The provision extends the qualified tuition deduction for two years so that it is generally available for taxable years beginning before January 1, 2012.

Effective Date

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

¹²⁴ The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

¹²⁵ Secs. 222(d)(1) and 25A(g)(2).

¹²⁶ Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

5. Tax-free distributions from individual retirement plans for charitable purposes (sec. 725 of the bill and sec. 408 of the Code)

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement (“IRA”) or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions. An exception applies in the case of a qualified charitable distribution.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to the following entities: (1) a charity described in section 501(c)(3); (2) certain veterans’ organizations, fraternal societies, and cemetery companies;¹²⁷ and (3) a Federal, State, or local governmental entity, but only if the contribution is made for exclusively public purposes.¹²⁸ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.¹²⁹

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.¹³⁰

A payment to a charity (regardless of whether it is termed a “contribution”) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any

¹²⁷ Secs. 170(c)(3)-(5).

¹²⁸ Sec. 170(c)(1).

¹²⁹ Secs. 170(b) and (e).

¹³⁰ Sec. 170(a).

such good or service provided) to the taxpayer in consideration for the contribution.¹³¹ In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.¹³²

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

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

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.¹³³ Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.¹³⁴ For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except

¹³¹ Sec. 170(f)(8). For any contribution of a cash, check, or other monetary gift, no deduction is allowed unless the donor maintains as a record of such contribution a bank record or written communication from the donee charity showing the name of the donee organization, the date of the contribution, and the amount of the contribution. Sec. 170(f)(17).

¹³² Sec. 6115.

¹³³ Secs. 170(f), 2055(e)(2), and 2522(c)(2).

¹³⁴ Sec. 170(f)(2).

to the extent the withdrawal represents a return of nondeductible contributions). Certain individuals also may make nondeductible contributions to a Roth IRA (deductible contributions cannot be made to Roth IRAs). Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by April 1 of the calendar year following the year in which the IRA owner attains age 70-½.¹³⁵

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;¹³⁶ (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.¹³⁷ Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

Qualified charitable distributions

Present law provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.¹³⁸

¹³⁵ Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

¹³⁶ Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

¹³⁷ Sec. 3405.

¹³⁸ Sec. 408(d)(8). The exclusion does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (“SEPs”).

The exclusion may not exceed \$100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. A qualified charitable distribution is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision. An IRA does not fail to qualify as an IRA as a result of qualified charitable distributions being made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½ and only to the extent the distribution would be includible in gross income (without regard to this provision).

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

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

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

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

Explanation of Provision

The provision extends the exclusion for qualified charitable distributions to distributions made in taxable years beginning after December 31, 2009 and before January 1, 2012. The provision contains a special rule permitting taxpayers to elect (in such form and manner as the

Secretary may prescribe) to have qualified charitable distributions made in January 2011 treated as having been made on December 31, 2010 for purposes of sections 408(a)(6), 408(b)(3), and 408(d)(8). Thus, a qualified charitable distribution made in January 2011 is permitted to be (1) treated as made in the taxpayer's 2010 taxable year and thus permitted to count against the 2010 \$100,000 limitation on the exclusion, and (2) treated as made in the 2010 calendar year and thus permitted to be used to satisfy the taxpayer's minimum distribution requirement for 2010.

Effective Date

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

6. Look-thru of certain regulated investment company stock in determining gross estate of nonresidents (sec. 726 of the bill and sec. 2105 of the Code)

Present Law

The gross estate of a decedent who was a U.S. citizen or resident generally includes all property – real, personal, tangible, and intangible – wherever situated.¹³⁹ The gross estate of a nonresident non-citizen decedent, by contrast, generally includes only property that at the time of the decedent's death is situated within the United States.¹⁴⁰ Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments, but does not include either bank deposits or portfolio obligations the interest on which would be exempt from U.S. income tax under section 871.¹⁴¹ Stock owned and held by a nonresident non-citizen generally is treated as property within the United States if the stock was issued by a domestic corporation.¹⁴²

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

Although stock issued by a domestic corporation generally is treated as property within the United States, stock of a regulated investment company ("RIC") that was owned by a nonresident non-citizen is not deemed property within the United States in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death,

¹³⁹ Sec. 2031. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. EGTRRA, however, included a termination provision under which EGTRRA's rules, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

¹⁴⁰ Sec. 2103.

¹⁴¹ Secs. 2104(c), 2105(b).

¹⁴² Sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (the “estate tax look-through rule for RIC stock”).¹⁴³ This estate tax look-through rule for RIC stock does not apply to estates of decedents dying after December 31, 2009.

Explanation of Provision

The provision permits the estate tax look-through rule for RIC stock to apply to estates of decedents dying before January 1, 2012.

Effective Date

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

7. Parity for exclusion from income for employer-provided mass transit and parking benefits (sec. 727 of the bill and sec. 132 of the Code)

Present Law

In general

Qualified transportation fringe benefits provided by an employer are excluded from an employee’s gross income for income tax purposes and from an employee’s wages for payroll tax purposes.¹⁴⁴ Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement). Qualified transportation fringe benefits also include a cash reimbursement by an employer to an employee. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Prior to February 17, 2009, the amount that could be excluded as qualified transportation fringe benefits was limited to \$100 per month in combined vanpooling and transit pass benefits and \$175 per month in qualified parking benefits. All limits were adjusted annually for inflation, using 1998 as the base year (in 2009 the limits were \$120 and \$230, respectively). The American Recovery and Reinvestment Act of 2009, however, temporarily increased the monthly exclusion for employer-provided vanpool and transit pass benefits to the same level as the exclusion for employer-provided parking (\$230 for 2010). The American Recovery and Reinvestment Act of 2009 limits are set to expire on December 31, 2010.

¹⁴³ Sec. 2105(d).

¹⁴⁴ Secs. 132(f), 3121(b)(2), and 3306(b)(16) and 3401(a)(19).

Explanation of Provision

The provision extends the parity in qualified transportation fringe benefits for one year (through December 31, 2011).

Effective Date

The provision is effective for months after December, 2010.

8. Refunds disregarded in the administration of Federal programs and Federally assisted programs (sec. 728 of the bill and sec. 6409 of the Code)

Present Law

Qualifying individuals may receive refundable credits under various provisions in the Code. Some of these credits are not taken into account for purposes of determining eligibility for benefits or assistance under Federal programs, but the treatment of such credits is not uniform. For example, for purposes of determining an individual's eligibility under any Federal program or federally funded State or local program, the child tax credit¹⁴⁵ is not considered a resource for the month of receipt and the following month,¹⁴⁶ but the making work pay credit¹⁴⁷ is not so considered for the month of receipt and the following two months.¹⁴⁸ The earned income credit has a similar rule to the child tax credit but only with respect to certain specifically listed benefit programs.¹⁴⁹

Explanation of Provision

Under this provision, any tax refund (or advance payment with respect to a refundable credit) received by an individual after December 31, 2009 begins a period of 12 months during which such refund may not be taken into account as a resource for purposes of determining the eligibility of such individual (or any other individual) for benefits or assistance (or the amount or extent of benefits or assistance) under any Federal program or under any State or local program financed in whole or in part with Federal funds. The provision terminates on December 31, 2012.

¹⁴⁵ Sec. 24.

¹⁴⁶ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, sec. 203.

¹⁴⁷ Sec. 36A.

¹⁴⁸ American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 1001(c).

¹⁴⁹ Sec. 32(l).

Effective Date

The provision is effective for amounts received after December 31, 2009 and on or before December 31, 2012.

C. Business Tax Relief

1. Research credit (sec. 731 of the bill and sec. 41 of the Code)

Present Law

General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.¹⁵⁰ Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.¹⁵¹

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009.¹⁵²

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that

¹⁵⁰ Sec. 41.

¹⁵¹ Sec. 41(e).

¹⁵² Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.¹⁵³

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.¹⁵⁴ Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.¹⁵⁵

Alternative simplified credit

Taxpayers may elect to claim an alternative simplified credit for qualified research expenses. The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.

Eligible expenses

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

¹⁵³ The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

¹⁵⁴ Sec. 41(f)(1).

¹⁵⁵ Sec. 41(f)(3).

taxpayer's behalf (so-called contract research expenses).¹⁵⁶ Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.¹⁵⁷ In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.¹⁵⁸ Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.¹⁵⁹ However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.¹⁶⁰ Taxpayers

¹⁵⁶ Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

¹⁵⁷ Sec. 41(d)(3).

¹⁵⁸ Sec. 41(d)(4).

¹⁵⁹ Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

¹⁶⁰ Sec. 280C(c).

may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.¹⁶¹

Explanation of Provision

The provision extends the research credit for two years, through December 31, 2011.

Effective Date

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

2. Indian employment tax credit (sec. 732 of the bill and sec. 45A of the Code)

Present Law

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.¹⁶² The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974¹⁶³ or section 4(10) of the Indian Child Welfare Act of 1978.¹⁶⁴ For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee

¹⁶¹ Sec. 280C(c)(3).

¹⁶² Sec. 45A.

¹⁶³ Pub. L. No. 93-262.

¹⁶⁴ Pub. L. No. 95-608.

during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjusted for inflation is currently \$45,000 for 2009). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years that begin before January 1, 2010.

Explanation of Provision

The provision extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2011).

Effective Date

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

3. New markets tax credit (sec. 733 of the bill and sec. 45D of the Code)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").¹⁶⁵ The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.¹⁶⁶ The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.¹⁶⁷ The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed.¹⁶⁸

¹⁶⁵ Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

¹⁶⁶ Sec. 45D(a)(2).

¹⁶⁷ Sec. 45D(a)(3).

¹⁶⁸ Sec. 45D(g).

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE.¹⁶⁹ A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.¹⁷⁰ Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.¹⁷¹

A “low-income community” is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income.¹⁷² For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary is authorized to designate “targeted populations” as low-income communities for purposes of the new markets tax credit.¹⁷³ For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994¹⁷⁴ (the “Act”) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area,

¹⁶⁹ Sec. 45D(c).

¹⁷⁰ Sec. 45D(b).

¹⁷¹ Sec. 45D(d).

¹⁷² Sec. 45D(e).

¹⁷³ Sec. 45D(e)(2).

¹⁷⁴ Pub. L. No. 103-325.

less than the greater of--80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.¹⁷⁵ A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391 of the Code, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of the business is used in a low-income community; (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.¹⁷⁶

The maximum annual amount of qualified equity investments was \$5.0 billion for calendar years 2008 and 2009. The new markets tax credit expired on December 31, 2009.

Explanation of Provision

The provision extends the new markets tax credit for two years, through 2011, permitting up to \$3.5 billion in qualified equity investments for each of the 2010 and 2011 calendar years. The provision also extends for two years, through 2016, the carryover period for unused new markets tax credits.

Effective Date

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

4. Railroad track maintenance credit (sec. 734 of the bill and sec. 45G of the Code)

Present Law

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during taxable years beginning before January 1, 2010.¹⁷⁷ The credit is limited to the product of \$3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.¹⁷⁸ Each mile of railroad track may be

¹⁷⁵ Pub. L. No. 103-325.

¹⁷⁶ Sec. 45D(d)(2).

¹⁷⁷ Sec. 45G(a).

¹⁷⁸ Sec. 45G(b)(1).

taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit may also reduce a taxpayer's tax liability below its tentative minimum tax.¹⁷⁹

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).¹⁸⁰

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.¹⁸¹

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.¹⁸²

Explanation of Provision

The provision extends the present law credit for two years, for qualified railroad track maintenance expenses paid or incurred during taxable years beginning after December 31, 2009 and before January 1, 2012.

Effective Date

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

5. Mine rescue team training credit (sec. 735 of the bill and sec. 45N of the Code)

Present Law

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) \$10,000. A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to

¹⁷⁹ Sec. 38(c)(4).

¹⁸⁰ Sec. 45G(d).

¹⁸¹ Sec. 45G(c).

¹⁸² Sec. 45G(e)(1).

serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction. The credit is not allowable for purposes of computing the alternative minimum tax.¹⁸³

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. The term "wages" has the meaning given to such term by section 3306(b)¹⁸⁴ (determined without regard to any dollar limitation contained in that section).

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.¹⁸⁵ The credit does not apply to taxable years beginning after December 31, 2009. Additionally, the credit may not offset the alternative minimum tax.

Explanation of Provision

The provision extends the credit for two years through taxable years beginning on or before December 31, 2011.

Effective Date

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

6. Employer wage credit for employees who are active duty members of the uniformed services (sec. 736 of the bill and sec. 45P of the Code)

Present Law

Differential pay

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

¹⁸³ Sec. 38(c).

¹⁸⁴ Section 3306(b) defines wages for purposes of Federal Unemployment Tax.

¹⁸⁵ Sec. 280C(e).

Wage credit for differential pay

If an employer qualifies as an eligible small business employer, the employer is allowed to take a credit against its income tax liability for a taxable year in an amount equal to 20 percent of the sum of the eligible differential wage payments for each of the employer's qualified employees for the taxable year.¹⁸⁶

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

Differential wage payment means any payment which: (1) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services of the United States while on active duty for a period of more than 30 days; and (2) represents all or a portion of the wages that the individual would have received from the employer if the individual were performing services for the employer. The term eligible differential wage payments means so much of the differential wage payments paid to a qualified employee as does not exceed \$20,000. A qualified employee is an individual who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

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

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

¹⁸⁶ Sec. 45P.

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

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

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

The credit is available with respect to amounts paid after June 17, 2008¹⁸⁷ and before January 1, 2010.

Explanation of Provision

The provision extends the availability of the credit to amounts paid before January 1, 2012.

Effective Date

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

7. 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements (sec. 737 of the bill and sec. 168 of the Code)

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.¹⁸⁸ The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the

¹⁸⁷ This date is the date of enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245.

¹⁸⁸ Sec. 168.

property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2010. Qualified leasehold improvement property is recovered using the straight-line method and a half-year convention. Leasehold improvements placed in service after December 31, 2009 will be subject to the general rules described above.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

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

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2010. Qualified restaurant property is any section 1250 property that is a building (if the building is placed in service after December 31, 2008 and before January 1, 2010) or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises

consumption of, prepared meals.¹⁸⁹ Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for bonus depreciation.¹⁹⁰ Restaurant property placed in service after December 31, 2009 is subject to the general rules described above.

Qualified retail improvement property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period and for qualified retail improvement property placed in service after December 31, 2008 and before January 1, 2010. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public¹⁹¹ and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

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

Qualified retail improvement property is recovered using the straight-line method and a half-year convention. Additionally, qualified retail improvement property is not eligible for bonus depreciation.¹⁹² Qualified retail improvement property placed in service on or after January 1, 2010 is subject to the general rules described above.

¹⁸⁹ Sec. 168(e)(7)(A).

¹⁹⁰ Property that satisfies the definition of both qualified leasehold improvement property and qualified restaurant property is eligible for bonus depreciation.

¹⁹¹ Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the provision.

¹⁹² Property that satisfies the definition of both qualified leasehold improvement property and qualified retail property is eligible for bonus depreciation.

Explanation of Provision

The present law provisions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property are extended for two years to apply to property placed in service on or before December 31, 2011.

Effective Date

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

8. 7-year recovery period for motorsports entertainment complexes (sec. 738 of the bill and sec. 168 of the Code)

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.¹⁹³ The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month. Land improvements (such as roads and fences) are recovered over 15 years. An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years. Additionally, a motorsports entertainment complex placed in service before December 31, 2009 is assigned a recovery period of seven years.¹⁹⁴ For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land and which during the 36-month period following its placed-in-service date hosts a racing event.¹⁹⁵ The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

Explanation of Provision

The provision extends the present law seven-year recovery period for motorsports entertainment complexes two years to apply to property placed in service before January 1, 2012.

¹⁹³ Sec. 168.

¹⁹⁴ Sec. 168(e)(3)(C)(ii).

¹⁹⁵ Sec. 168(i)(15).

Effective Date

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

9. Accelerated depreciation for business property on an Indian reservation (sec. 739 of the bill and sec. 168(j) of the Code)

Present Law

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) are determined using the following recovery periods:

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

“Qualified Indian reservation property” eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;¹⁹⁶ and (4) is not property placed in service for purposes of conducting gaming activities.¹⁹⁷ Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).¹⁹⁸

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974¹⁹⁹ or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C.

¹⁹⁶ For these purposes, related persons is defined in Sec. 465(b)(3)(C).

¹⁹⁷ Sec. 168(j)(4)(A).

¹⁹⁸ Sec. 168(j)(4)(C).

¹⁹⁹ Pub. L. No. 93-262.

1903(10)).²⁰⁰ For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

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

Explanation of Provision

The provision extends for two years the present-law accelerated MACRS recovery periods for qualified Indian reservation property to apply to property placed in service before January 1, 2012.

Effective Date

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

10. Enhanced charitable deduction for contributions of food inventory (sec. 740 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions in general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.²⁰¹

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

²⁰⁰ Pub. L. No. 95-608.

²⁰¹ Sec. 170.

General rules regarding contributions of food inventory

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.²⁰² In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.²⁰³ To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.²⁰⁴ In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.²⁰⁵

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.²⁰⁶ Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.²⁰⁷

²⁰² Sec. 170(e)(3).

²⁰³ Sec. 170(b)(2).

²⁰⁴ Sec. 170(e)(3)(A)(i)-(iii).

²⁰⁵ Sec. 170(e)(3)(A)(iv).

²⁰⁶ Treas. Reg. sec. 1.170A-4A(c)(3).

²⁰⁷ *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

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

Under a special temporary provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory.²⁰⁸ For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.²⁰⁹

Under the temporary provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." Apparently wholesome food is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

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

Explanation of Provision

The provision extends the expansion of, and modifications to, the enhanced deduction for charitable contributions of food inventory to contributions made before January 1, 2012.

Effective Date

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

²⁰⁸ Sec. 170(e)(3)(C).

²⁰⁹ The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

11. Enhanced charitable deduction for contributions of book inventories to public schools (sec. 741 of the bill and sec. 170 of the Code)

Present Law

Charitable contributions in general

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.²¹⁰

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

General rules regarding contributions of book inventory

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or, if less, the fair market value of the inventory.

In general, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.²¹¹ In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income.²¹² To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.²¹³ In the case of contributed property subject to the Federal

²¹⁰ Sec. 170.

²¹¹ Sec. 170(e)(3).

²¹² Sec. 170(b)(2).

²¹³ Sec. 170(e)(3)(A)(i)-(iii).

Food, Drug, and Cosmetic Act, as amended, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.²¹⁴

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory.²¹⁵ Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

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

The generally applicable enhanced deduction for C corporations is expanded and modified to include certain qualified book contributions made after August 28, 2005, and before January 1, 2010.²¹⁶ A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction for qualified book contributions is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs. The donee also must make the certifications required for the generally applicable enhanced deduction, i.e., the donee will (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

Explanation of Provision

The provision extends the expansion of, and modifications to, the enhanced deduction for contributions of book inventory to contributions made before January 1, 2012.

Effective Date

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

²¹⁴ Sec. 170(e)(3)(A)(iv).

²¹⁵ Treas. Reg. sec. 1.170A-4A(c)(3).

²¹⁶ Sec. 170(e)(3)(D).

12. Enhanced charitable deduction for corporate contributions of computer inventory for educational purposes (sec. 742 of the bill and sec. 170 of the Code)

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.²¹⁷

Explanation of Provision

A taxpayer's deduction for charitable contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. Under a special, temporary provision, certain corporations may claim a deduction in excess of basis for a "qualified computer contribution."²¹⁸ This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2009.²¹⁹

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets several requirements. The contribution must meet standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property (or, if the taxpayer constructed or assembled the property, the date construction or assembly of the property is substantially completed).²²⁰ The original use of the property must be by the donor or the donee,²²¹ and substantially all of the donee's use of the property must be within the United States for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed or assembled by the taxpayer, the rules

²¹⁷ Sec. 170(e)(1).

²¹⁸ Sec. 170(e)(6).

²¹⁹ Sec. 170(e)(6)(G).

²²⁰ If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

²²¹ This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.²²²

Explanation of Provision

The provision extends the enhanced deduction for computer technology and equipment to contributions made before January 1, 2012.

Effective Date

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

13. Election to expense mine safety equipment (sec. 743 of the bill and sec. 179E of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”).²²³ Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or “expense”) such costs under section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2010 is \$500,000 of the cost of the qualifying property for the taxable year. 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.²²⁴ The \$500,000 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 \$2,000,000.

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in

²²² Sec. 170(e)(6)(C).

²²³ Sec. 168.

²²⁴ The definition of qualifying property was temporarily (for 2010 and 2011) expanded to include up to \$250,000 of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. See section 179(c).

service.²²⁵ The deduction under section 179E is allowed for both regular and alternative minimum tax purposes, including adjusted current earnings. In computing earnings and profits, the amount deductible under section 179E is allowed as a deduction ratably over five taxable years beginning with the year the amount is deductible under section 179E.²²⁶

“Qualified advanced mine safety equipment property” means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service before January 1, 2010.²²⁷

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.²²⁸

The portion of the cost of any property with respect to which an expensing election under section 179 is made may not be taken into account for purposes of the 50-percent deduction under section 179E.²²⁹ In addition, a taxpayer making an election under section 179E must file with the Secretary a report containing information with respect to the operation of the mines of the taxpayer as required by the Secretary.²³⁰

Explanation of Provision

The provision extends for two years, to December 31, 2011, the present-law placed in service date relating to expensing of mine safety equipment.

Effective Date

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

²²⁵ Sec. 179E(a).

²²⁶ Sec. 312(k)(3). Section 56(g)(4)(C)(i) does not apply to a deduction under section 179E (or under sections 179, 179A, 179B, and 179D), as such deduction is permitted for purposes of computing earnings and profits.

²²⁷ Secs. 179E(c) and (g).

²²⁸ Sec. 179E(d).

²²⁹ Sec. 179E(e).

²³⁰ Sec. 179E(f).

14. Special expensing rules for certain film and television productions (sec. 744 of the bill and sec. 181 of the Code)

Present Law

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

Under section 181, taxpayers may elect²³¹ to deduct the cost of any qualifying film and television production, commencing prior to January 1, 2010, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.²³² Taxpayers may elect to deduct up to \$15 million of the aggregate cost of the film or television production under this section.²³³ The threshold is increased to \$20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.²³⁴

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.²³⁵ The term “compensation” does not include participations and residuals

²³¹ See Treas. Reg. section 1.181-2T for rules on making an election under this section.

²³² For this purpose, a production is treated as commencing on the first date of principal photography.

²³³ Sec. 181(a)(2)(A).

²³⁴ Sec. 181(a)(2)(B).

²³⁵ Sec. 181(d)(3)(A).

(as defined in section 167(g)(7)(B)).²³⁶ With respect to property which is one or more episodes in a television series, each episode is treated as a separate production and only the first 44 episodes qualify under the provision.²³⁷ Qualified property does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.²³⁸

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.²³⁹

Explanation of Provision

The provision extends the present law expensing provision for two years, to qualified film and television productions commencing prior to January 1, 2012.

Effective Date

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

15. Expensing of environmental remediation costs (sec. 745 of the bill and sec. 198 of the Code)

Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.²⁴⁰ Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense.²⁴¹ Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define “capital expenditures” as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use.²⁴² Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on all relevant facts and circumstances.

²³⁶ Sec. 181(d)(3)(B).

²³⁷ Sec. 181(d)(2)(B).

²³⁸ Sec. 181(d)(2)(C).

²³⁹ Sec. 1245(a)(2)(C).

²⁴⁰ Sec. 162.

²⁴¹ Treas. Reg. sec. 1.162-4.

²⁴² Treas. Reg. sec. 1.263(a)-1(b).

Taxpayers may elect to treat certain environmental remediation expenditures paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred.²⁴³ The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*²⁴⁴ and section 263A are treated as qualified environmental remediation expenditures.

A “qualified contaminated site” (a so-called “brownfield”) generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”)²⁴⁵ cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use, as well as petroleum products defined in section 4612(a)(3) of the Code.

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under section 198.

Explanation of Provision

The provision extends the present law expensing for two years to include expenditures paid or incurred before January 1, 2012.

Effective Date

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

²⁴³ Sec. 198.

²⁴⁴ 418 U.S. 1 (1974).

²⁴⁵ Pub. L. No. 96-510 (1980).

16. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 746 of the bill and sec. 199 of the Code)

Present Law

General

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

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

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property²⁴⁶ that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film²⁴⁷ produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.²⁴⁸ Wages paid to bona fide residents of Puerto Rico

²⁴⁶ Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

²⁴⁷ Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

²⁴⁸ For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year.

generally are not included in the definition of wages for purposes of computing the wage limitation amount.²⁴⁹

Rules for Puerto Rico

When used in the Code in a geographical sense, the term “United States” generally includes only the States and the District of Columbia.²⁵⁰ A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term “United States” includes the Commonwealth of Puerto Rico, but only if all of the taxpayer’s Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations.²⁵¹ In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.²⁵²

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

Explanation of Provision

The provision allows the special domestic production activities rules for Puerto Rico to apply for the first six taxable years of a taxpayer beginning after December 31, 2005 and before January 1, 2012.

Effective Date

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

17. Modification of tax treatment of certain payments to controlling exempt organizations (sec. 747 of the bill and sec. 512 of the Code)

Present Law

In general, organizations exempt from Federal income tax are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt

²⁴⁹ Section 3401(a)(8)(C) excludes wages paid to United States citizens who are bona fide residents of Puerto Rico from the term wages for purposes of income tax withholding.

²⁵⁰ Sec. 7701(a)(9).

²⁵¹ Sec. 199(d)(8)(A).

²⁵² Sec. 199(d)(8)(B).

functions.²⁵³ In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations.²⁵⁴

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. In general, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50-percent controlled by the parent tax-exempt organization to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). However, a special rule provides that, for payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule of section 512(b)(13) applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the principles of section 482 (i.e., at arm's length).²⁵⁵ In addition, the special rule imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, "control" means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

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

Explanation of Provision

The provision extends the special rule to payments received or accrued before January 1, 2012. Accordingly, under the provision, payments of rent, royalties, annuities, or interest income by a controlled organization to a controlling organization pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), may be includible in the unrelated business taxable income of the controlling organization only to the extent the payment exceeds the amount of the payment determined under the principles of section 482 (i.e., at arm's length). Any such excess is subject to a 20-percent penalty on the larger of such excess determined without regard to any amendment or

²⁵³ Sec. 511.

²⁵⁴ Sec. 512(b).

²⁵⁵ Sec. 512(b)(13)(E).

supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

Effective Date

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

18. Treatment of certain dividends of regulated investment companies (sec. 748 of the bill and sec. 871(k) of the Code)

Present Law²⁵⁶

In general

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

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

Explanation of Provision

The provision extends the rules exempting from gross basis tax and from withholding tax the interest-related dividends and short term capital gain dividends received from a RIC, to dividends with respect to taxable years of a RIC beginning before January 1, 2012.

²⁵⁶ Secs. 871(k), 881, 1441 and 1442.

Effective Date

The provision applies to dividends paid with respect to any taxable year of the RIC beginning after December 31, 2009.

19. RIC qualified investment entity treatment under FIRPTA (sec. 749 of the bill and secs. 897 and 1445 of the Code)

Present law

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

A USRPI includes stock or a beneficial interest in any domestic corporation unless such corporation has not been a U.S. real property holding corporation (as defined) during the testing period. A USRPI does not include an interest in a domestically controlled “qualified investment entity.” A distribution from a “qualified investment entity” that is attributable to the sale of a USRPI is also subject to tax under FIRPTA unless the distribution is with respect to an interest that is regularly traded on an established securities market located in the United States and the recipient foreign corporation or nonresident alien individual did not hold more than 5 percent of that class of stock or beneficial interest within the 1-year period ending on the date of distribution.²⁵⁷ Special rules apply to situations involving tiers of qualified investment entities.

The term “qualified investment entity” includes a real estate investment trust (“REIT”) and also includes a regulated investment company (“RIC”) that meets certain requirements, although the inclusion of a RIC in that definition does not apply for certain purposes after December 31, 2009.²⁵⁸

Explanation of Provision

The provision extends the inclusion of a RIC within the definition of a “qualified investment entity” under section 897 of the Code through December 31, 2011, for those situations in which that inclusion would otherwise have expired at the end of 2009.

²⁵⁷ Sections 857(b)(3)(F), 852(b)(3)(E), and 871(k)(2)(E) require dividend treatment, rather than capital gain treatment, for certain distributions to which FIRPTA does not apply by reason of this exception. See also section 881(e)(2).

²⁵⁸ Section 897(h).

Effective Date

The provision is generally effective on January 1, 2010.

The provision does not apply with respect to the withholding requirement under section 1445 for any payment made before the date of enactment, but a RIC that withheld and remitted tax under section 1445 on distributions made after December 31, 2009 and before the date of enactment is not liable to the distributee with respect to such withheld and remitted amounts.

20. Exceptions for active financing income (sec. 750 of the bill and secs. 953 and 954 of the Code)

Present Law

Under the subpart F rules,²⁵⁹ 10-percent-or-greater U.S. shareholders of a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits (“REMICs”); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC’s country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC’s country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC’s country of organization is taxable as subpart F insurance income.²⁶⁰

²⁵⁹ Secs. 951-964.

²⁶⁰ Prop. Treas. Reg. sec. 1.953-1(a).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called “active financing income”). These provisions were enacted in the Taxpayer Relief Act of 1997 as one-year temporary exceptions, and in 1998, 1999, 2002, 2006, and 2008, the provisions were extended, and in some cases, modified.²⁶¹

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country’s tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

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

In the case of insurance, a temporary exception from foreign personal holding company income applies for certain income of a qualifying insurance company with respect to risks located within the CFC’s country of creation or organization. In the case of insurance,

²⁶¹ Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009. The Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) extended the temporary provisions for one year, for taxable years beginning after 2008 and before 2010.

temporary exceptions from insurance income and from foreign personal holding company income also apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met. In the case of a life insurance or annuity contract, reserves for such contracts are determined under rules specific to the temporary exceptions. Present law also permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.

Explanation of Provision

The provision extends for two years (for taxable years beginning before 2012) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

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

21. Look-thru treatment of payments between related controlled foreign corporations under foreign personal holding company rules (sec. 751 of the bill and sec. 954(c)(6) of the Code)

Present Law

In general

The rules of subpart F²⁶² require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (“CFC”) to include certain income of the CFC (referred to as “subpart F income”) on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the United States that is effectively connected with the conduct by such CFC of a trade or business within the United States (“ECI”) unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

The “look-thru rule”

Under the “look-thru rule” (sec. 954(c)(6)), dividends, interest (including factoring income that is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC’s stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-thru rule, including such regulations as are appropriate to prevent the abuse of the purposes of such rule.

²⁶² Secs. 951-964.

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

Explanation of Provision

The provision extends for two years the application of the look-thru rule, to taxable years of foreign corporations beginning before January 1, 2012, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Effective Date

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

22. Basis adjustment to stock of S corps making charitable contributions of property (sec. 752 of the bill and sec. 1367 of the Code)

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.²⁶³ A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.²⁶⁴

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

Explanation of Provision

The provision extends the rule relating to the basis reduction on account of charitable contributions of property for two years to contributions made in taxable years beginning before January 1, 2012.

²⁶³ Sec. 1366(a)(1)(A).

²⁶⁴ Sec. 1367(a)(2)(B).

Effective Date

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

23. Empowerment zone tax incentives (sec. 753 of the bill and secs. 1391 and 1202 of the Code)

Present Law

The Omnibus Budget Reconciliation Act of 1993 (“OBRA 93”)²⁶⁵ authorized the designation of nine empowerment zones (“Round I empowerment zones”) to provide tax incentives for businesses to locate within certain targeted areas²⁶⁶ designated by the Secretaries of the Department of Housing and Urban Development (“HUD”) and the U.S. Department of Agriculture (“USDA”). The Taxpayer Relief Act of 1997²⁶⁷ authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones (“Round II empowerment zones”). The Community Renewal Tax Relief Act of 2000 (“2000 Community Renewal Act”)²⁶⁸ authorized a total of ten new empowerment zones (“Round III empowerment zones”), bringing the total number of authorized empowerment zones to 40.²⁶⁹ In addition, the 2000 Community Renewal Act conformed the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009.²⁷⁰

²⁶⁵ Pub. L. No. 103-66.

²⁶⁶ The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

²⁶⁷ Pub. L. No. 105-34.

²⁶⁸ Pub. L. No. 106-554.

²⁶⁹ The urban part of the program is administered by the HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA; Baltimore, MD; Chicago, IL; Cleveland, OH; Detroit, MI; Los Angeles, CA; New York, NY; and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY; Mid-Delta, MI; and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA; Cincinnati, OH; Columbia, SC; Columbus, OH; Cumberland County, NJ; El Paso, TX; Gary/Hammond/East Chicago, IN; Ironton, OH/Huntington, WV; Knoxville, TN; Miami/Dade County, FL; Minneapolis, MN; New Haven, CT; Norfolk/Portsmouth, VA; Santa Ana, CA; and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA; Griggs-Steele, ND; Oglala Sioux Tribe, SD; Southernmost Illinois Delta, IL; and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA; Jacksonville, FL; Oklahoma City, OK; Pulaski County, AR; San Antonio, TX; Syracuse, NY; Tucson, AZ; and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME; and Futuro, TX.

²⁷⁰ If an empowerment zone designation were terminated prior to December 31, 2009, the tax incentives would cease to be available as of the termination date.

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

The following is a description of the tax incentives.

Employment credit

A 20-percent wage credit is available to employers for the first \$15,000 of qualified wages paid to each employee (i.e., a maximum credit of \$3,000 with respect to each qualified employee) who (1) is a resident of the empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.²⁷¹

The wage credit rate applies to qualifying wages paid before January 1, 2010. Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an “enterprise zone business.”²⁷²

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.²⁷³ Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer’s work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.²⁷⁴ In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.²⁷⁵ The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.²⁷⁶

²⁷¹ Sec. 1396. The \$15,000 limit is annual, not cumulative such that the limit is the first \$15,000 of wages paid in a calendar year which ends with or within the taxable year.

²⁷² Secs. 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to: (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

²⁷³ Sec. 280C(a).

²⁷⁴ Secs. 1396(c)(3)(A) and 51A(d)(2).

²⁷⁵ Secs. 1396(c)(3)(B) and 51A(d)(2).

²⁷⁶ Sec. 38(c)(2).

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional \$35,000 of section 179 expensing (for a total of up to \$285,000 in 2009)²⁷⁷ for qualified zone property placed in service before January 1, 2010.²⁷⁸ The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$500,000.²⁷⁹ The term “qualified zone property” is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.²⁸⁰

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35

²⁷⁷ For each of 2010 and 2011, the 179 expensing limitation will be a total of up to \$535,000. The Small Business Jobs Act of 2010, Pub. L. No. 111-240. See discussion above at IV.B.

²⁷⁸ Secs. 1397A, 1397D.

²⁷⁹ Sec. 1397A(a)(2), 179(b)(2), (7). For 2008 and 2009, the limit is \$800,000.

²⁸⁰ Sec. 1397C(b).

percent of such employees are residents of an empowerment zone; (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than 5 percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.²⁸¹

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.²⁸² In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

Expanded tax-exempt financing for certain zone facilities

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.²⁸³ These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).²⁸⁴

Second, a business that qualifies as at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the

²⁸¹ Sec. 1397C(c).

²⁸² Sec. 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack, or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. Sec. 144(c)(6).

²⁸³ Sec. 1394.

²⁸⁴ Sec. 1394(b)(3).

three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

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

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

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset²⁸⁵ held for more than one year and replaced within 60 days by another qualified empowerment zone asset in the same zone.²⁸⁶ The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

Partial exclusion of capital gains on certain small business stock

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.²⁸⁷ The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

²⁸⁵ The term "qualified empowerment zone asset" means any property which would be a qualified community asset (as defined in section 1400F, relating to certain tax benefits for renewal communities) if in section 1400F: (i) references to empowerment zones were substituted for references to renewal communities, (ii) references to enterprise zone businesses (as defined in section 1397C) were substituted for references to renewal community businesses, and (iii) the date of the enactment of this paragraph were substituted for "December 31, 2001" each place it appears. Sec. 1397B(b)(1)(A).

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

For the definition of "enterprise zone business," see text accompanying *supra* note 280. For the definition of "qualified business," see text accompanying *supra* note 280.

²⁸⁶ Sec. 1397B.

²⁸⁷ Sec. 1202.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.²⁸⁸ A percentage of the excluded gain is an alternative minimum tax preference;²⁸⁹ the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Gain from the sale of qualified small business stock generally is taxed at effective rates of 14 percent under the regular tax²⁹⁰ and (i) 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.²⁹¹

Temporary increases in exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, is increased to 75 percent.

The percentage exclusion for qualified small business stock acquired after September 27, 2010, and before January 1, 2011, is increased to 100 percent.²⁹²

The temporary increases in the exclusion percentage apply for all qualified small business stock, including stock of empowerment zone businesses.²⁹³

Other tax incentives

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

²⁸⁸ Sec. 1(h).

²⁸⁹ Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

²⁹⁰ The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

²⁹¹ The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

²⁹² Sec. 760 of the bill extends the January 1, 2011, date to January 1, 2012.

²⁹³ Secs. 1202(a)(3)(B) and 1202(a)(4)(B).

Explanation of Provision

The provision extends for two years, through December 31, 2011, the period for which the designation of an empowerment zone is in effect, thus extending for two years the empowerment zone tax incentives, including the wage credit, accelerated depreciation deductions on qualifying equipment, tax-exempt bond financing, and deferral of capital gains tax on sale of qualified assets sold and replaced. In the case of a designation of an empowerment zone the nomination for which included a termination date which is December 31, 2009, termination shall not apply with respect to such designation if the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary may provide.

The provision extends for two years, through December 31, 2016, the period for which the percentage exclusion for qualified small business stock (of a corporation which is a qualified business entity) acquired on or before February 17, 2009 is 60 percent. Gain attributable to periods after December 31, 2016 for qualified small business stock acquired on or before February 17, 2009 or after December 31, 2011 is subject to the general rule which provides for a percentage exclusion of 50 percent.

Effective Date

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

24. Tax incentives for investment in the District of Columbia (sec. 754 of the bill and secs. 1400, 1400A, 1400B, and 1400C of the Code)

Present Law

In general

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the “District of Columbia Enterprise Zone,” or “DC Zone,” within which businesses and individual residents are eligible for special tax incentives. The census tracts that comprise the District of Columbia Enterprise Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District of Columbia), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The District of Columbia Enterprise Zone designation remains in effect for the period from January 1, 1998, through December 31, 2009.

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

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

Employment credit

A 20-percent wage credit is available to employers for the first \$15,000 of qualified wages paid to each employee (i.e., a maximum credit of \$3,000 with respect to each qualified employee) who (1) is a resident of the District of Columbia, and (2) performs substantially all employment services within an empowerment zone in a trade or business of the employer.

The wage credit rate applies to qualifying wages paid after December 31, 2001, and before January 1, 2010. Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an “enterprise zone business,” as defined below.

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year. Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer’s work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A. In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit. The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.

Increased section 179 expensing limitation

An enterprise zone business is allowed an additional \$35,000 of section 179 expensing (for a total of up to \$285,000 in 2009)²⁹⁴ for qualified zone property placed in service after December 31, 2001, and before January 1, 2010. The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$500,000. The term “qualified zone property” is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer. For this purpose, special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means, any corporation or partnership if for such

²⁹⁴ For each of 2010 and 2011, the 179 expensing limitation will be a total of up to \$535,000. The Small Business Jobs Act of 2010, Pub. L. No. 111-240. See discussion above at IV.B.

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

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

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

Expanded tax-exempt financing for certain zone facilities

An enterprise zone business is permitted to borrow proceeds from the issuance of tax-exempt enterprise zone facility bonds (as defined in section 1394, without regard to the employee residency requirement) issued by the District of Columbia. To qualify, 95 percent (or more) of the net proceeds must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property. Accordingly, most of the proceeds have to be used to finance certain facilities within the DC Zone. The aggregate face amount of all outstanding qualified enterprise zone

facility bonds per enterprise zone business may not exceed \$15 million and may be issued only while the DC Zone designation is in effect, from January 1, 1998 through December 31, 2009.

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

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

Zero-percent capital gains

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

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

District of Columbia homebuyer tax credit

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

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

taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.

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

Explanation of Provision

The provision extends for two years, through December 31, 2011, the designation of the District of Columbia Enterprise Zone. The provision also extends for two years through December 31, 2011, the special \$15 million per-user bond limitation and the relief from resident and employee requirements for certain tax-exempt bonds issued in the District of Columbia Enterprise Zone.

The provision extends for two years the zero-percent capital gains rate applicable to capital gains from the sale or exchange of any DC Zone asset held for more than five years (and, as amended, acquired or substantially improved before January 1, 2012). The provision also extends for two years the period to which the term "qualified capital gain" refers. As amended, the term "qualified capital gain" shall not include any gain attributable to periods before January 1, 1998, or after December 31, 2016.

The provision extends the first-time D.C. homebuyer credit for two years (as amended, to apply to property purchased before January 1, 2012).

Effective Date

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

25. Temporary increase in limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands (sec. 755 of the bill and sec. 7652(f) of the Code)

Present Law

A \$13.50 per proof gallon²⁹⁵ excise tax is imposed on distilled spirits produced in or imported into the United States.²⁹⁶ The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).²⁹⁷

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.²⁹⁸ The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon before January 1, 2010).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.²⁹⁹ Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.³⁰⁰ All of the amounts covered over are subject to the limitation.

Explanation of Provision

The provision suspends for two years the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over limitation of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2009 and before January 1, 2012. After December 31, 2011, the cover over amount reverts to \$10.50 per proof gallon.

²⁹⁵ A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

²⁹⁶ Sec. 5001(a)(1).

²⁹⁷ Secs. 5214(a)(1)(A), 5002(a)(15), 7653(b) and (c).

²⁹⁸ Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

²⁹⁹ Sec. 7652(e)(2).

³⁰⁰ Secs. 7652(a)(3), (b)(3), and (e)(1).

Effective Date

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

26. American Samoa economic development credit (sec. 756 of the bill and sec. 119 of Pub. L. No. 109-432)

Present Law

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

A corporation was an existing credit claimant with respect to a American Samoa if (1) the corporation was engaged in the active conduct of a trade or business within American Samoa on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit³⁰¹ in an election in effect for its taxable year that included October 13, 1995.³⁰² A corporation that added

³⁰¹ For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit. Secs. 27(b), 936. This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions. Subject to certain limitations, discussed below, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment. No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under section 936.

Under the economic activity-based limit, the amount of the credit could not exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes. A taxpayer could elect, instead of the economic activity-based limit, a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income, beginning in 1998, the applicable percentage was 40 percent.

To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business. Sec. 936(a)(2). The section 936 credit generally expired for taxable years beginning after December 31, 2005.

³⁰² A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and

a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

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

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

The credit applies to the first four taxable years of a taxpayer which begin after December 31, 2005, and before January 1, 2010.

Explanation of Provision

The provision allows the credit to apply to the first six taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2012.

Effective Date

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

27. Work opportunity credit (sec. 757 of the bill and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the

(2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

employer (two years in the case of an individual in the long-term family assistance recipient category).

Targeted groups eligible for the credit

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

(1) Families receiving TANF

An eligible recipient is an individual certified by a designated local employment agency (e.g., a State employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program (“TANF”) for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

(2) Qualified veteran

There are two subcategories of qualified veterans related to eligibility for food stamps and compensation for a service-connected disability.

Food stamps

A qualified veteran is a veteran who is certified by the designated local agency as a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Entitled to compensation for a service-connected disability

A qualified veteran also includes an individual who is certified as entitled to compensation for a service-connected disability and: (1) having a hiring date which is not more than one year after having been discharged or released from active duty in the Armed Forces of the United States; or (2) having been unemployed for six months or more (whether or not consecutive) during the one-year period ending on the date of hiring.

Definitions

For these purposes, being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S. Code, which means having a disability rating of 10 percent or higher for service connected injuries.

For these purposes, a veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any

individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(3) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law; and (2) having a hiring date within one year of release from prison or the date of conviction.

(4) Designated community residents

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community or a rural renewal community. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget) which had a net population loss during the five-year periods 1990-1994 and 1995-1999. Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community or a rural renewal community.

(5) Vocational rehabilitation referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code; or (c) an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified summer youth employee

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15; (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date; (3) who has not been an employee of that employer before; and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community. As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day

period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified food stamp recipient

A qualified food stamp recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

(8) Qualified SSI recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income (“SSI”) benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

(9) Long-term family assistance recipients

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)³⁰³ if the individual is hired within two years after the date that the 18-month total is reached; or (3) a member of a family who is no longer eligible for family assistance because of either Federal or State time limits, if the individual is hired within two years after the Federal or State time limits made the family ineligible for family assistance.

(10) Unemployed veterans and disconnected youth hired in 2009 and 2010

Unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010 are treated as a targeted category under section 1221(a) of the American Recovery and Reinvestment Act of 2009.³⁰⁴

An unemployed veteran is defined as an individual certified by the designated local agency as someone who: (1) has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the

³⁰³ The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006, for qualified individuals who begin to work for an employer after December 31, 2006.

³⁰⁴ (Pub. L. No. 111-5)

Armed Forces for a service-connected disability; (2) has been discharged or released from active duty in the Armed Forces during the five-year period ending on the hiring date; and (3) has received unemployment compensation under State or Federal law for not less than four weeks during the one-year period ending on the hiring date.

A disconnected youth is defined as an individual certified by the designated local agency as someone: (1) at least age 16 but not yet age 25 on the hiring date; (2) not regularly attending any secondary, technical, or post-secondary school during the six-month period preceding the hiring date; (3) not regularly employed during the six-month period preceding the hiring date; and (4) not readily employable by reason of lacking a sufficient number of skills.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in sec. 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

Calculation of the credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

In the case of a qualified veteran who is entitled to compensation for a service connected disability, the credit equals 40 percent of \$12,000 of qualified first-year wages. This expanded definition of qualified first-year wages does not apply to the veterans qualified with reference to a food stamp program, as defined under present law.

Certification rules

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after August 31, 2011.

Explanation of Provision

The provision extends the work opportunity tax credit for four months (for individuals who begin work for an employer after August 31, 2011 before January 1, 2012).³⁰⁵

³⁰⁵ The rule to allow unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010 to be treated as members of a targeted group is not extended.

Effective Date

The provisions are effective for individuals who begin work for an employer after August 31, 2011.

28. Qualified zone academy bonds (sec. 758 of the Act and sec. 54E of the Code)

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. These can include tax-exempt bonds which finance public schools.³⁰⁶ An issuer must file with the Internal Revenue Service certain information about the bonds issued in order for that bond issue to be tax-exempt.³⁰⁷ Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds does not apply to any arbitrage bond.³⁰⁸ An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.³⁰⁹ In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue “qualified zone academy bonds.”³¹⁰ A total of \$400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2008. That is increased to \$1,400 million in 2009 and 2010. Each calendar year’s bond limitation is allocated to the States according to their respective populations of individuals below

³⁰⁶ Sec. 103.

³⁰⁷ Sec. 149(e).

³⁰⁸ Sec. 103(a) and (b)(2).

³⁰⁹ Sec. 148.

³¹⁰ See secs. 54E and 1397E.

the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.³¹¹ The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the principal on the bond is 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

The arbitrage requirements which generally apply to interest-bearing tax-exempt bonds also generally apply to qualified zone academy bonds. In addition, an issuer of qualified zone academy bonds must reasonably expect to and actually spend 100 percent or more of the proceeds of such bonds on qualified zone academy property within the three-year period that begins on the date of issuance. To the extent less than 100 percent of the proceeds are used to finance qualified zone academy property during the three-year spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem any nonqualified bonds. The three-year spending period may be extended by the Secretary if the issuer establishes that the failure to meet

³¹¹ Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence.

Two special arbitrage rules apply to qualified zone academy bonds. First, available project proceeds invested during the three-year period beginning on the date of issue are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). Available project proceeds are proceeds from the sale of an issue of qualified zone academy bonds, less issuance costs (not to exceed two percent) and any investment earnings on such proceeds. Thus, available project proceeds invested during the three-year spending period may be invested at unrestricted yields, but the earnings on such investments must be spent on qualified zone academy property. Second, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified zone academy bonds are issued.

Issuers of qualified zone academy bonds are required to report issuance to the Internal Revenue Service in a manner similar to the information returns required for tax-exempt bonds.

For bonds originally issued after March 18, 2010, an issuer of qualified zone academy bonds may make an irrevocable election on or before the issue date of such bonds to receive a payment under section 6431 in lieu of providing a tax credit to the holder of the bonds. The payment to the issuer on each payment date is equal to the lesser of (1) the amount of interest payable on such bond by such issuer with respect to such date or (2) the amount of the interest which would have been payable under such bond on such date if such interest were determined at the applicable tax credit bond rate.

Explanation of Provision

In general

The provision extends the qualified zone academy bond program for one year. The provision authorizes issuance of up to \$400 million of qualified zone academy bonds for 2011.

The issuer election to receive a payment in lieu of providing a tax credit to the holder of the qualified zone academy bond is not available for bonds issued with the 2011 national limitation. The provision has no effect on bonds issued with limitation carried forward from 2009 or 2010.

Effective Date

The provision applies to obligations issued after December 31, 2010.

29. Mortgage insurance premiums (sec. 759 of the bill and sec. 163 of the Code)

Present Law

In general

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

Acquisition indebtedness and home equity indebtedness

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is \$100,000. The maximum amount of acquisition indebtedness is \$1 million. Acquisition indebtedness means debt that is incurred in acquiring constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

Private mortgage insurance

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each \$1,000 by which the taxpayer's adjusted gross income exceeds \$100,000 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds \$110,000 (\$55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration,³¹² or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

³¹² The Veterans Administration and the Rural Housing Administration have been succeeded by the Department of Veterans Affairs and the Rural Housing Service, respectively.

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2010, or properly allocable to any period after that date.

Reporting rules apply under the provision.

Explanation of Provision

The provision extends the deduction for private mortgage insurance premiums for one year (only with respect to contracts entered into after December 31, 2006). Thus, the provision applies to amounts paid or accrued in 2011 (and not properly allocable to any period after 2011).

Effective Date

The provision is effective for amounts paid or accrued after December 31, 2010.

30. Temporary exclusion of 100 percent of gain on certain small business stock (sec. 760 of the bill and sec. 1202 of the Code)

Present Law

In general

Individuals generally may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.³¹³ The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.³¹⁴ A percentage of the excluded gain is an alternative minimum tax preference;³¹⁵ the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

³¹³ Sec. 1202.

³¹⁴ Sec. 1(h).

³¹⁵ Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010. Section 102 of the bill extends the 2010 and 2011 dates by two years.

Gain from the sale of qualified small business stock generally is taxed at effective rates of 14 percent under the regular tax³¹⁶ and (i) 14.98 percent under the alternative minimum tax for dispositions before January 1, 2011; (ii) 19.88 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under the alternative minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.³¹⁷

Temporary increases in exclusion

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, is increased to 75 percent. As a result of the increased exclusion, gain from the sale of this qualified small business stock held at least five years is taxed at effective rates of seven percent under the regular tax³¹⁸ and 12.88 percent under the alternative minimum tax.³¹⁹

The percentage exclusion for qualified small business stock acquired after September 27, 2010, and before January 1, 2011, is increased to 100 percent and the minimum tax preference does not apply.³²⁰ The minimum tax preference does not apply.

Explanation of Provision

The provision extends the 100-percent exclusion and the exception from minimum tax preference treatment for one year (for stock acquired before January 1, 2012).

Effective Date

The provision is effective for stock acquired after December 31, 2010.

³¹⁶ The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

³¹⁷ The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

³¹⁸ The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

³¹⁹ The 46 percent of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

³²⁰ Sec. 1202(a)(4)(A) and (C).

D. Temporary Disaster Relief Provisions

1. New York Liberty Zone tax-exempt bond financing (sec. 761 of the bill and sec. 1400L of the Code)

Present Law

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

Explanation of Provision

The provision extends authority to issue Liberty Zone bonds for two years (through December 31, 2011).

Effective Date

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

2. Increase in rehabilitation credit in the Gulf Opportunity Zone (sec. 762 of the bill and sec. 1400N(h) of the Code)

Present Law

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

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) \$5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

Present law increases from 20 to 26 percent, and from 10 to 13 percent, respectively, the credit under section 47 with respect to any certified historic structure or qualified rehabilitated

building located in the Gulf Opportunity Zone, provided the qualified rehabilitation expenditures with respect to such buildings or structures are incurred on or after August 28, 2005, and before January 1, 2010. The provision is effective for expenditures incurred on or after August 28, 2005, for taxable years ending on or after August 28, 2005.

Explanation of Provision

The provision extends for two additional years the increase in the rehabilitation credit from 20 to 26 percent, and from 10 to 13 percent, respectively, with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone. Thus, the increase applies for qualified rehabilitation expenditures with respect to such buildings or structures incurred before January 1, 2012.

Effective Date

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

3. Low-income housing credit rules for buildings in Gulf Opportunity Zones (sec. 763 and sec. 1400N(c)(5) of the Code)

Present Law

In general

The low-income housing credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Volume limit

Generally, a low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Each State has a limited amount of low-income housing credit available to allocate. This amount is called the aggregate housing credit dollar amount (or the "State housing credit ceiling"). For each State, the State housing credit ceiling is the sum of four components: (1) the unused housing credit ceiling, if any, of such State from the prior calendar year; (2) the credit ceiling for the year (either a per capital amount or the small State minimum annual cap); (3) any returns of credit ceiling to the State during the calendar year from previous allocations; and (4) the State's

share, if any, of the national pool of unused credits from other States that failed to use them (only States which allocated their entire credit ceiling for the preceding calendar year are eligible for a share of the national pool. For calendar year 2010, each State's credit ceiling is \$2.10 per resident, with a minimum annual cap of \$2,430,000 for certain small population States.³²¹ These amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

Under section 1400N(c) of the Code, the otherwise applicable State housing credit ceiling is increased for each of the States within the Gulf Opportunity Zone. This increase applies to calendar years 2006, 2007, and 2008. The additional volume for each of the affected States equals \$18.00 times the number of such State's residents within the Gulf Opportunity Zone. This amount is not adjusted for inflation. This additional volume limit expires unless the applicable low-income buildings are placed in service before January 1, 2011.

Explanation of Provision

The provision extends the placed-in-service deadline (for one year) to December 31, 2011.

Effective Date

The provision is effective on the date of enactment.

4. Tax-exempt bond financing for the Gulf Opportunity Zones (sec. 764 of the bill and sec. 1400N(a) of the Code)

Present Law

In general

Under present law, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes an exempt facility bond and a qualified mortgage bond.

³²¹ Rev. Proc. 2009-50.

Exempt facility bonds

The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

Residential rental property may be financed with exempt facility bonds if the financed project is a “qualified residential rental project.” A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the “20-50 test”). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”).

Qualified mortgage bonds

Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a “first-time homebuyer” requirement. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or replace existing mortgages.

Exceptions to the new mortgage requirement are provided for the replacement of construction period loans, bridge loans, and other similar temporary initial financing. In addition, qualified rehabilitation loans may be used, in part, to replace existing mortgages. A qualified rehabilitation loan means certain loans for the rehabilitation of a building if there is a period of at least 20 years between the date on which the building was first used (the “20 year rule”) and the date on which the physical work on such rehabilitation begins and the existing walls and basis requirements are met. The existing walls requirement for a rehabilitated building is met if 50 percent or more of the existing external walls are retained in place as external walls, 75 percent or more of the existing external walls are retained in place as internal or external walls, and 75 percent or more of the existing internal structural framework is retained in place. The basis requirement is met if expenditures for rehabilitation are 25 percent or more of the mortgagor’s adjusted basis in the residence, determined as of the later of the completion of the rehabilitation or the date on which the mortgagor acquires the residence.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the

property. Qualified home-improvement loans may not exceed \$15,000, and may not be used to refinance existing mortgages.

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the “State volume cap”).

Gulf Opportunity Zone Bonds

The Gulf Opportunity Zone Act of 2005 authorizes Alabama, Louisiana, and Mississippi (or any political subdivision of those States) to issue qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone (“Gulf Opportunity Zone Bonds”). Gulf Opportunity Zone Bonds are not subject to the State volume cap. Rather, the maximum aggregate amount of Gulf Opportunity Zone Bonds that may be issued in any eligible State is limited to \$2,500 multiplied by the population of the respective State within the Gulf Opportunity Zone.

Depending on the purpose for which such bonds are issued, Gulf Opportunity Zone Bonds are treated as either exempt facility bonds or qualified mortgage bonds. Gulf Opportunity Zone Bonds are treated as exempt facility bonds if 95 percent or more of the net proceeds of such bonds are to be used for qualified project costs located in the Gulf Opportunity Zone. Qualified project costs include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property (including buildings and their structural components and fixed improvements associated with such property), qualified residential rental projects (as defined in section 142(d) with certain modifications), and public utility property. Bond proceeds may not be used to finance movable fixtures and equipment.

Rather than applying the 20-50 and 40-60 test from section 142, a project is a qualified residential rental project under the provision if 20 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income or if 40 percent or more of the residential units in such project are occupied by individuals whose income is 70 percent or less of area median gross income.

Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone are treated as qualified mortgage bonds if the general requirements for qualified mortgage bonds are met. The Code also provides special rules for Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone. For example, the first-time homebuyer rule is waived and the income and purchase price rules are relaxed for residences financed in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. In addition, the Code increases from \$15,000 to \$150,000 the amount of a qualified home-improvement loan with respect to residences located in the specified disaster areas.

Also, a qualified GO Zone repair or reconstruction loan is treated as a qualified rehabilitation loan for purposes of the qualified mortgage bond rules. Thus, such loans financed with the proceeds of qualified mortgage bonds and Gulf Opportunity Zone Bonds may be used to acquire or replace existing mortgages, without regard to the existing walls or 20 year rule under present law. A qualified GO Zone repair or reconstruction loan is any loan used to repair damage caused by Hurricane Katrina, Hurricane Rita, or Hurricane Wilma to a building located

in the GO Zones (or reconstruction of such building in the case of damage constituting destruction) if the expenditures for such repair or reconstruction are 25 percent or more of the mortgagor's adjusted basis in the residence. For these purposes, the mortgagor's adjusted basis is determined as of the later of (1) the completion of the repair or reconstruction or (2) the date on which the mortgagor acquires the residence.

Gulf Opportunity Zone Bonds must be issued before January 1, 2011.

Explanation of Provision

The provision extends authority to issue Gulf Opportunity Zone Bonds for one year (through December 31, 2011).

Effective Date

The provision is effective on the date of enactment.

5. Bonus depreciation deduction applicable to specified Gulf Opportunity Zone extension property (sec. 765 of the bill and sec. 1400N(d)(6) of the Code)

Present Law

In general

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008, 2009, and 2010 (2009, 2010, and 2011 for certain longer-lived and transportation property).³²² The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in section 168(e)(5)); (3) computer software other than computer software covered by section 197; or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).³²³ Second, the

³²² Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under section 263 or section 263A.

³²³ The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. The additional first-year depreciation deduction is

original use³²⁴ of the property must commence with the taxpayer after December 31, 2007.³²⁵ Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2011. An extension of the placed in service date of one year (i.e., to January 1, 2012) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.³²⁶ Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2011, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2011.³²⁷ With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2011. 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. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred

also not available for qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

³²⁴ The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

³²⁵ A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

³²⁶ Property qualifying for the extended placed in service date must have an estimated production period exceeding one year and a cost exceeding \$1 million.

³²⁷ Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

before January 1, 2011 (“progress expenditures”) is eligible for the additional first-year depreciation.³²⁸

Gulf Opportunity Zone Additional Depreciation

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of specified qualified Gulf Opportunity Zone extension property. To qualify, property generally must be placed in service on or before December 31, 2010. Specified Gulf Opportunity Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a building described in (1), property described in section 168(k)(2)(A)(i),³²⁹ if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service. However, in the case of nonresidential real property or residential rental property, only the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2010 is eligible for the additional first-year depreciation.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone which are in a county or parish which is identified by the Secretary of the Treasury (or his delegate) as being a county or parish in which hurricanes occurring in 2005 damaged (in the aggregate) more than 60 percent of the housing units in such county or parish which were occupied (determined according to the 2000 Census).

Explanation of Provision

The provision extends for one year through December 31, 2011, the date by which specified Gulf Opportunity Zone extension property must be placed in service to be eligible for the additional first-year depreciation deduction. In the case of nonresidential real property or residential rental property, the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2012 is eligible for the additional first-year depreciation.

Effective Date

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

³²⁸ For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

³²⁹ Generally, property described in section 168(k)(2)(A)(i) is (1) property to which the general rules of the Modified Accelerated Cost Recovery System (“MACRS”) apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), or (4) certain leasehold improvement property.