1 EXECUTIVE COMMITTEE MEETING TO CONSIDER AN ORIGINAL BILL
2 THAT WILL INCLUDE THE COMMITTEE'S BUDGET RECONCILIATION
3 INSTRUCTIONS PERTAINING TO EXPIRING TAX PROVISIONS, AND
4 ADDITIONAL INCENTIVES FOR HURRICANE AFFECTED AREAS
5 TUESDAY, NOVEMBER 15, 2005
6 U.S. Senate,
7 Committee on Finance,
8 Washington, DC.
9 The meeting was convened, pursuant to notice, at
10 2:34 p.m., in room SD-215, Dirksen Senate Office
11 Building, Hon. Charles E. Grassley (chairman of the
12 committee) presiding.
13 Also present: Senators Hatch, Lott, Snowe, Kyl,
14 Thomas, Santorum, Frist, Smith, Bunning, Crapo, Baucus,
15 Rockefeller, Conrad, Jeffords, Bingaman, Kerry, Lincoln,
16 Wyden, and Schumer.
17 Also present: Robert Carroll, Deputy Assistant
18 Secretary, Department of Treasury, Office of Tax Policy;
19 George Yin, Chief of Staff, Joint Committee on Taxation.
20 Also present: Kolan Davis, Republican Staff
21 Director; Ted Totman, Republican Deputy Staff Director;
22 Dean Zerbe, Tax Counsel and Senior Counsel to the
23 Chairman; Russ Sullivan, Democratic Staff Director;
24 Carla Martin, Chief Clerk; and Amber Williams, Assistant
25 Clerk.

1 OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, CHAIRMAN,
2 COMMITTEE ON FINANCE
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4 The Chairman. Thank you all for joining me this
5 afternoon, and particularly to members of the committee.
6 I want to apologize for the fact that everything has been
7 so tenuous for this meeting, going back since last
8 Thursday. So, I appreciate everybody's cooperation.
9 The bill before the committee does three things.
10 First, it acts on our commitment to provide rebuilding
11 assistance to areas of the country devastated by
12 hurricanes.
13 Second, it provides tax relief for families by
14 ensuring that there is no interruption of tax provisions
15 that are expiring this year. In other words, on that
16 point we are going to have an automatic increase the
17 first of the year if we do not continue tax policy that
18 is already in place.
19 Then, lastly, it provides incentives for increased
20 charitable giving, while prohibiting transactions that
21 misuse or abuse charitable organizations and their
22 assets.
23 An important part of this bill is delivering on the
24 commitment we made to residents of the Gulf region, also
25 Texas and Florida, much-needed relief and resources for

1 economic rebuilding in those areas.

2 As promised, we have made our best effort to marry up
3 our compassion with displaced persons and damaged
4 communities with attention to fiscal discipline, and most
5 importantly, the best use of taxpayer dollars.

6 The bill represents an effort to most efficiently and
7 effectively use resources under this committee's
8 jurisdiction to assist in the rebuilding and
9 revitalization of that part of our country.

10 There are some guiding principles in this policy.
11 Because market forces will be the driver in getting these
12 regions back on their feet, our bill includes only
13 provisions that encourage and incentivize redevelopment.

14 Second, our package provides resources only to those
15 who incurred uninsured losses, and does not provide for a
16 bail-out of those who assumed risk as an insurer of our
17 capitalist free market system.

18 Third, we have focused our limited Federal resources
19 on those most in need, like the many devastated small
20 businesses who were the backbone of those States'
21 economies and who will be the engine for future growth.

22 Finally, the bill provides front-loaded incentives on
23 a timely basis to encourage people and businesses to
24 return to the region. This bill also extends popular tax
25 relief, ranging from tax deductions for families sending

1 kids to college to relief from the expanding reach of the
2 Alternative Minimum Tax. If we let these provisions
3 lapse, we in fact are raising taxes on a very significant
4 number of taxpayers.
5 These provisions benefit many taxpayers in each of
6 your States, so we have charts that reflect the data on a
7 State-by-State basis. These are the charts I am
8 referring to, so if you would look at these charts you
9 would know for the different provisions the number of
10 people that will be impacted in the respective States if
11 we do not take action.
12 I will also mention briefly some important
13 initiatives. The largest provision of the bill, $32
14 billion of tax relief--or maybe I had better say keeping
15 Americans who are not paying that tax today from paying
16 $32 billion more, and that is half of this net tax
17 package--deals then with the AMT.
18 This piece of the package affects 14 million American
19 families in every region of the Nation. The AMT is
20 terrible, and you have heard me say so many times it
21 ought to be repealed, like we did in 1998, except for the
22 fact that President Clinton vetoed that bill.
23 Until such time, we owe it to the American taxpayers
24 to see and ensure that they are not hit by this tax. The
25 mark also includes popular and broadly applicable tax

1 benefits, deductibility of college tuition, small savers
2 credit, small business expensing. These provisions,
3 without a doubt, enjoy almost unanimous bipartisan
4 support and millions of taxpayers rely on those.
5 The mark also addresses expiring business in
6 individual provisions that these committee members know
7 by the word "extenders." These provisions include a
8 research and development tax credit, State sales tax
9 deductibility, the Work Opportunity Tax Credit, and the
10 deduction for teachers' out-of-pocket expenses.
11 Finally, this mark includes many of the charitable
12 incentives introduced in the CARE Act, and they have
13 previously passed this committee, as well as the Senate.
14 And I need to thank Senators Santorum and Baucus in
15 working with me to balance these incentives with several
16 of the much-needed reforms that are supported by the
17 charitable sector, the Treasury Department, the IRS, and
18 donors and taxpayers, overall.
19 Now I would like to turn to Senator Baucus, please.
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1 OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM
2 MONTANA
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4 Senator Baucus. Thank you, Mr. Chairman.
5 The Chinese consider it a curse to say "May you live
6 in interesting times." Well, this has certainly been an
7 interesting mark-up.
8 Mr. Chairman, last Tuesday when you gave notice of
9 your intention to hold this mark-up I thought we were
10 going to have a knock-down, drag-out fight over capital
11 gains/dividends and the budget deficit, but now it
12 appears we are going to have an entirely different mark-
13 up. I am not complaining, I am gratified.
14 I am gratified that you have chosen to modify your
15 mark to remove the capital gains/dividend extension.
16 After all, we do not need it. It does not expire until
17 the end of 2008. That is a fundamental change, and from
18 this side of the dais, that is a welcome change.
19 You might recall, Mr. Chairman, a couple of weeks ago
20 you asked me if capital gains/dividends extension was
21 taken out, would I be willing to work with you, and I
22 said I would. Well, you took it out and I am here to say
23 I am here now to work with you.
24 The Chairman. Thank you. Thank you.
25 Senator Baucus. The job of the committee chairman

1 is a brokerage job, in many respects. The committee
2 chairman tries to do the most that he can with the votes
3 that he has, and I compliment you, Mr. Chairman, for
4 being among one of the best at counting votes.
5 Now, I have been musing that we might want to
6 consider changing our committee procedures. That is,
7 when a modification makes a change of this magnitude, one
8 might argue we should have an entirely new mark-up, new
9 notice, new opportunity to file amendments.
10 But most of the amendments on this side of the dais
11 had to do with striking capital gains and dividends
12 extension provisions and using the revenues for better
13 purposes, so most of those amendments will not be
14 necessary today.
15 For many reasons, the mark-up today is not all that I
16 would have preferred. I would have preferred that we had
17 handled this tax cut legislation outside of the
18 reconciliation straightjacket.
19 I would have preferred that we had done more to
20 address the immediate needs of the people affected by the
21 hurricanes that have ravaged the Gulf States. I would
22 have preferred that we had done more to address active
23 financing. I would have preferred that the committee
24 would have paid for the tax cuts that it proposes today.
25 But I know that the Chairman would have preferred

1 that this mark-up had gone a bit differently in other
2 ways. There are many good things in the mark. Extension
3 of the R&D credit is crucial for American businesses to
4 remain competitive. The devastated Gulf States
5 desperately need the help to rebuild that is in the mark.
6 I appreciate the work that you have done, Mr.
7 Chairman, to extend the tax provisions that we all know
8 need to be extended. This is the business, after all, of
9 the committee.
10 Going forward, I urge you, Mr. Chairman, to defend
11 this position, that is, including not extending the
12 dividends/capital gains extension, as aggressively and as
13 strenuously as you can, because after all, that will be
14 the Senate position.
15 The modification before the committee today
16 represents a moderate consensus. In particular, we must
17 resist the fiscally irresponsible road down which the
18 House of Representatives seems headed.
19 So, Mr. Chairman, this has been an interesting
20 process. The critic for *The New Yorker*, Alexander
21 Wolcott, once said, "The most interesting things in life
22 are either immoral, illegal, or too fattening."
23 As we move ahead on this interesting mark-up, let us
24 try to shape a bill that is none of those things. Let us
25 maintain a bill that has moral grounding. Let us extend

1 the laws that need extending, and let us avoid doing so
2 much that we fatten the deficit.
3 Thank you.
4 The Chairman. Thank you very much.
5 I would ask other members, if they want to speak--and
6 we did this at the last mark-up on the other
7 reconciliation on expenditures--to speak in three
8 minutes, and we will have a buzzer go off.
9 Senator Hatch, do you want to speak? You are next.
10 Senator Hatch. I would not mind saying a few words.
11 The Chairman. Go ahead.
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1 OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR
2 FROM UTAH
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4 Senator Hatch. Mr. Chairman, I have not yet had a
5 chance to examine it, but I understand the revised mark
6 includes a provision that would prevent certain
7 integrated oil companies from using the LIFO, last-in/
8 first-out method of accounting.
9 I am very concerned about this provision, Mr.
10 Chairman. It seems to be a back-door attempt to place a
11 windfall profits tax on oil companies, which was counter-
12 productive the first time it was tried.
13 I am even more concerned that this provision could
14 very well miss the intended target and hit some of the
15 smaller oil refineries around the Nation that we have
16 been trying to help in recent tax bills.
17 I am told that it would affect three companies in
18 Utah that happen to have some production, some refining,
19 and are, in addition, retailers. These three Utah
20 companies are not the large, integrated oil firms that
21 this revised mark may be targeting.
22 I do not think that this is good tax policy for even
23 the large companies, but in addition to being very poor
24 policy, in my opinion, it is also misdirected. Did we
25 not pass a provision to give small oil refineries a tax

1 benefit for complying with the cost of the new diesel
2 regulations?
3 Did we not pass an expensing provision to encourage
4 refineries to add to their capacity? Is this not like
5 giving someone a quarter with the right hand and then
6 taking a dollar away from that same person with their
7 left hand?
8 If we wish to encourage more production of oil, and
9 especially if we wish to encourage the creation of more
10 capacity to refine oil and oil products, both of which I
11 have been a strong supporter of, I do not think this is
12 the way to go about it.
13 I hope the Chairman will agree and work with me, and
14 others, to find a way to eliminate this provision when
15 the bill goes to the floor, or at least change it so that
16 these small Utahan companies and others similar are not
17 hit hard by it.
18 The Chairman. Senator Hatch, for my part, I want to
19 look at the economics of it. I am not in a position
20 right now to say absolutely that we would look at it and
21 take it out, but I have had a lot of concern, as you just
22 raised to me, and it will get a lot of my attention.
23 Senator Hatch. Well, thank you.
24 Is it possible for me to raise one other point?
25 The Chairman. Yes. Please go ahead. You still

1 have time.

2 Senator Hatch. I am very grateful that the revised

3 mark before us includes the expansion of the Research

4 Credit to add the simplified Alternative Research Credit

5 to the extension. This is a very important provision

6 that I think will strengthen the Research Credit.

7 However, I am deeply disturbed and puzzled by another

8 addition to the credit that also appears in the modified

9 Chairman's mark. This is the provision that makes so-

10 called "funded research" ineligible for the Research

11 Credit.

12 Now, I am wondering if Mr. Yin might explain this

13 provision to me and outline the rationale for it. Mr.

14 Chairman, I am concerned that this limitation can harm

15 some of the very research that we are trying to

16 incentivize with the Research Credit.

17 I am also concerned it could have a detrimental

18 effect or impact on our efforts to keep the U.S. as the

19 world's leader in research and development. So if I

20 could, is it all right to ask Mr. Yin a question?

21 The Chairman. Would you answer that? It is

22 probably easier right now to get it done now.

23 Senator Hatch. Yes. I would like to know what

24 would be the revenue effect of this definition change.

25 Mr. Yin. Senator Hatch, the revenue effect of that

1 particular aspect of the change is about $600 million
2 over the five-year period.
3 The Chairman. All right.
4 Now, Senator Jeffords, if you want to speak, your
5 turn is next. If not, I will go on to the next person.
6 Senator Jeffords. Go on.
7 The Chairman. All right.
8 Senator Thomas?
9 Senator Thomas. Thank you, Mr. Chairman. I want to
10 commend the Chairman for his hard work. I know that this
11 has been difficult to put together a package that
12 satisfies the budget reconciliation instructions,
13 particularly in the circumstances we face, and prevents a
14 number of tax increases that would otherwise
15 automatically take place.
16 I have always felt that a tax provision is good
17 policy, and if by its nature it is good policy, it ought
18 to remain, it is not short-term, and should be permanent
19 policy.
20 So I understand the present bills are limited by
21 revenue constraints, making a number of these provisions
22 permanent and otherwise limiting others from being
23 addressed. I hope we can continue to achieve and seek to
24 achieve good tax policy.
25 I want to comment on Senator Hatch's comments. I

1 feel very strongly about the LIFO revenue raiser and I
2 think this is very bad policy to make this change and
3 apply it only to certain areas in a particular commodity.
4 As a matter of fact, I intend to suggest a limitation
5 to that in this meeting today, and suggest a limitation
6 be put on that. And whether I call for a vote or not is
7 another matter, but I do want to raise the question that
8 I have, and I have a substitute amendment.
9 The Chairman. Just in case you missed the point, I
10 made a commitment to Senator Hatch that I was going to
11 take a real close look at the economics of that and the
12 detrimental impact of it, and act accordingly.
13 I just did not want to say to Senator Hatch right now
14 that I was for taking that out right now, but I wanted to
15 make sure that it is going to get our attention. In
16 fact, I would say that a lot of you on this committee
17 have already gotten my attention on that point.
18 Senator Thomas. We would like to continue to do
19 that, Mr. Chairman. [Laughter].
20 The Chairman. All right.
21 Senator Smith of Oregon, if you have a speech, you
22 are next.
23 Senator Smith. Mr. Chairman, I will put mine in the
24 record, in the interest of time. But I will also serve
25 notice that I would like to offer an amendment on

1 mortgage insurance as a deduction.

2 The Chairman. Do you have an offset?

3 Senator Smith. I believe we will.

4 The Chairman. All right.

5 [The prepared statement of Senator Smith appears in

6 the appendix.]

7 The Chairman. Mr. Bunning, you are next if you have

8 a point you want to make.

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1 OPENING STATEMENT OF HON. JIM BUNNING, A U.S. SENATOR
2 FROM KENTUCKY
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4 Senator Bunning. Thank you, Mr. Chairman. I would
5 like to express my support for the Tax Relief Act of
6 2005. I am glad that we are finally revisiting this
7 bill.
8 I have heard a lot the last few weeks from some of my
9 colleagues, talking about how we cannot afford tax cuts
10 that this bill was expected to contain. As we have been
11 saying for weeks, the growth package is not about tax
12 cuts, it is about stopping tax increases, tax increases
13 that will affect every American family.
14 The so-called tax cuts that Democrat members of
15 Congress are talking about are nothing more than just
16 keeping current tax law in place. There are over 40
17 provisions that the American families and employers have
18 come to rely on that will expire at the end of this year
19 if we do nothing. These are provisions that are
20 important to our constituents and to our economy.
21 Let us take a look at just a few of them in the bill
22 before us. The R&D tax credit was mentioned before. It
23 will expire at the end of this year if we do not act.
24 This is an important provision and one that almost every
25 member of this committee supports. I thank the Chairman

1 for working with us to improve this provision in today's
2 modification.
3 A lot of other important provisions will also expire
4 if we do not act: the deduction for tuition expenses was
5 mentioned, the tax deduction for teachers' classroom
6 expenses, and others.
7 I am extremely disappointed that this bill does not
8 contain a provision that I consider to be vitally
9 important, keeping the tax rates on dividends and capital
10 gains income from increasing. It is very important that
11 it extends this 15 rate through the end of the budget
12 window.
13 As this bill moves through the legislation process, I
14 will fight to make sure that this bill that the President
15 ultimately signs will include these vital provisions. It
16 is very hard to dispute the positive impact that the 15
17 percent rates have had on the macro economy.
18 Dividends paid by companies in the S&P 500 are up 59
19 percent since this change was implemented and capital
20 gains revenues to the Federal Government is set to exceed
21 the CBO forecast by $16 billion in fiscal year 2006.
22 As we know, these dividends are very important to the
23 elderly. Many of our retired folks rely on dividends to
24 supplement their fixed income, and from their pensions
25 and Social Security. I would ask that the rest of my

1 statement be put into the record.

2 The Chairman. Thank you, Senator Bunning.

3 [The prepared statement of Senator Bunning appears in

4 the appendix.]

5 The Chairman. Now, Senator Crapo?

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1 OPENING STATEMENT OF HON. MIKE CRAPO, A U.S. SENATOR FROM
2 IDAHO
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4 Senator Crapo. Thank you very much, Mr. Chairman.
5 I, too, want to indicate that I will support the mark
6 today because of the many very positive things that are
7 included in this mark.
8 I do so, though, with great reservation because of
9 the very, very significant things that are not included
10 in the mark. It has already been mentioned that the
11 removal of the dividends and capital gains has been done,
12 and I just want to talk about that for a minute because I
13 think it is a very serious mistake.
14 My understanding is that corporate tax revenue in
15 this country is up 47 percent since we made these changes
16 in the Tax Code, and some of my colleagues have already
17 discussed some of the significant benefit to the economy
18 that has occurred because we have unshackled our
19 businesses in this country so that they can manage
20 themselves for business purposes rather than the Tax
21 Code.
22 Now we seem prepared to say that that is not so
23 important any more and we are willing to run right up
24 against the deadline again before we take any action to
25 give any certainty to the marketplace.

1 According to AARP, 77 percent of all dividend income
2 is earned by people over the age of 50. People over the
3 age of 65 earn 48 percent of all dividend income. So if
4 we do not lower the rate on dividends, it is our seniors
5 that will face the largest burden of the taxes by our
6 inaction.
7 For many Americans, reduced taxes on their dividend
8 income means a higher standard of living. In 2003, 18
9 million taxable returns reported qualifying dividend
10 income, and 54 percent of those were from filers with
11 adjusted gross incomes of under $75,000. The average
12 dividend income for these filers was $1,400.
13 I want to just take a quick look, just like I have
14 done in previous meetings, Mr. Chairman, and talk about
15 what that means for people in Idaho. If you look at
16 capital gains, 18.5 percent, in the year 2003, of
17 577,000, almost 578,000 tax returns filed in Idaho, paid
18 capital gains taxes. Of those, 107,000 returns were
19 filers who had incomes under $75,000.
20 If you look at dividends, in 2003, 20.7 percent of
21 the 577,000 tax returns filed in Idaho reported dividend
22 income. Of those, 119,000 households received dividends,
23 86,605 of those households had adjusted gross incomes of
24 under 75,000.
25 I have kind of garbled these statistics, but the

1 point is, this is not a tax just for business, this is a
2 tax that we are going to play games with here today, if
3 we do not put it in the bill, that will impact Americans
4 across the board.

5 I just want to say that, although I understand what
6 is going to happen today, this is just the first step in
7 the process and I am committed to make sure that as this
8 process moves forward to a final bill that makes it to
9 the President's desk, that we do include the extension of
10 the tax relief for capital gains and dividends.

11 The Chairman. Thank you, Senator Crapo.

12 Now, Senator Kyl?

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1 OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM
2 ARIZONA
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4 Senator Kyl. Thank you, Mr. Chairman. I would like
5 to second the comments that Senator Crapo just made.
6 This is not the first time, and I am sure it will not be
7 the last time, that I have supported a bill in committee
8 for the sole purpose of getting it to the floor, and
9 eventually to conference.
10 But if it did not have capital gains and dividends,
11 the continuation of the tax relief in that for American
12 taxpayers, I would not be able to support this bill. It
13 is, in many respects, the centerpiece of this
14 legislation. We ought not to be doing the bill without
15 that key element.
16 Let me just take, nationally, the same type of
17 statistics that Senator Crapo was just talking to you
18 about. For some reason, there is a view among some that
19 the tax rate for people who receive dividends and who pay
20 capital gains is somehow only for the wealthy.
21 The reality is, 17 percent of all tax filers, spread
22 evenly across income categories, reported capital gains
23 in the year 2003, and 23 percent of all filers, dividends
24 income.
25 Of all filers reporting capital gains income in 2003,

1 30 percent--almost a third--had adjusted gross incomes
2 under $30,000, and only 8.7 percent had incomes above
3 $200,000. Similarly, for dividends income, over 30
4 percent had adjusted gross incomes under $30,000, and
5 only 6.9 percent more than $200,000.
6 Contrast those numbers with the Saver's Credit. Only
7 4 percent of filers benefitted from the Saver's Credit.
8 Above-the-line deduction for college tuition costs, only
9 2.7 percent of filers claimed this deduction. AMT, only
10 6 percent.
11 Now, we know that is going to double, but still that
12 is less than the filers for either capital gains or
13 dividends. These are important for American taxpayers
14 and we have got to demonstrate our commitment to them
15 that we are not going to allow their taxes to increase.
16 That is why we have got to ensure that when this bill
17 comes back from the conference, that it does include the
18 extension of those tax rates.
19 Why now, because they do not expire for two years?
20 Anybody that knows anything about investing knows that
21 you want to know what the tax rate is when you cash out
22 your investment, and there are not very many investments
23 that are less than two years.
24 So the point here is, if you are going to make an
25 investment that is going to last four or five years, you

1 want to know what the tax rate is at that time. It is
2 going to be 20 percent higher if we allow these
3 provisions to expire.
4 So, now is precisely the time to ensure that our
5 taxpayers do not get an increase in their taxes when they
6 have capital gains or dividends. To make the point
7 again, these two taxes apply to about a third of the
8 filers who file for tax liability in the United States.
9 It is critical that we come back from conference with
10 these provisions intact, and I am confident we will do so
11 or I would not be able to support this bill, Mr.
12 Chairman.
13 The Chairman. Senator Snowe, then Senator Wyden,
14 then Senator Lott, in that order.
15 Senator Snowe?
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1 OPENING STATEMENT OF HON. OLYMPIA J. SNOWE, A U.S.
2 SENATOR FROM MAINE
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4 Senator Snowe. Thank you, Mr. Chairman. I want to
5 thank you for undertaking an enormously difficult task in
6 leading us to the Chairman's mark that is before us
7 today.
8 It is obviously a course that has been forged by, in
9 my view, historic confluences of challenges that we face,
10 and I know it has not been an easy course to chart. I
11 want to commend you for your diligence and patience in
12 bringing this Chairman's mark before us today.
13 Mr. Chairman, I happen to believe that it is not a
14 question of whether or not we support tax cuts, it really
15 is a question of what we can afford to do now in this
16 current economic and fiscal climate that really does
17 require us to set priorities and to make some tough
18 choices.
19 The modifications in the Chairman's mark, I think
20 certainly have made and met the obligations that we need
21 to establish with respect to the delicate balancing act
22 within our budget and our budgetary priorities. I do
23 believe we have a fundamental obligation to create that
24 equilibrium.
25 Frankly, I think the Chairman's mark is appropriately

1 right-sized within the context of the challenges that we
2 currently face as a Nation. The reality is, this is a
3 very different world than where we were even six months
4 ago when we enacted the budget resolution.
5 Yes, we have a $319 billion deficit--albeit it is
6 $100 billion improved--but it is in the framework of a
7 $1.6 trillion deficit over the next five years. In
8 addition, the deficit is compounded by unforseen events:
9 three back-to-back hurricanes and the unprecedented
10 challenge of rebuilding the Gulf region; the ongoing
11 operations in Iraq and, therefore, the ongoing costs,
12 further complicated by the energy crisis and spiraling
13 increases in home heating oil, natural gas, kerosene, and
14 propane.
15 We are not even in the midst of winter and my
16 constituents are already facing 30 to 50 percent
17 increases in home heating oil. The fact is, these are a
18 confluence of challenges that require a confluence of
19 choices.
20 That is why I think we have taken, in the Chairman's
21 mark, a fiscally practical and responsible approach given
22 the difficulties and the enormity of the challenges that
23 we face in this country today.
24 We preserve our options within the context of these
25 historic deficits, and at the same time we only extend

1 those tax cuts that are expiring this year or next year,
2 and one in 2007. That is a practical approach rather
3 than extending those tax cuts that expire three years
4 from now.
5 Finally, I hope that we will end the fiscal shell
6 game of having, every year, tax cuts that expire or
7 sunset. We ought to get to a point, if we think they are
8 important enough, that we establish permanent policy with
9 respect to those tax cuts, Mr. Chairman.
10 So, again, I want to thank you for adopting a
11 fiscally responsible approach given this current fiscal
12 climate and environment.
13 Thank you, Mr. Chairman.
14 The Chairman. Thank you, Senator Snowe.
15 Now, Senator Wyden?
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1 OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM
2 OREGON
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4 Senator Wyden. Thank you, Mr. Chairman.
5 Mr. Chairman, recently there have been record oil
6 prices, we have seen record profits, and yet the oil
7 companies get record tax breaks.
8 Last week, we had the executives of all of the major
9 oil companies before the Congress and I just asked them
10 point-blank, do you need these tax breaks. To a person,
11 every one of them said no. In fact, that squares with
12 what the President has said.
13 The President said, "With $55 oil, we don't need
14 incentives for oil and gas companies to explore." Now,
15 the price of oil is currently above $57 per barrel, even
16 higher than the President said we do not need any
17 incentives.
18 So to me, it just defies common sense for the
19 Congress to be shoveling tax breaks at this industry when
20 even the executives say they are not needed. Now, the
21 argument that has been advanced in the past when we have
22 talked about it is, well, this is needed for the small
23 products.
24 The laws, however, do not restrict the tax breaks to
25 the small producers. They apply to everybody. So what I

1 am going to do in the course of this mark-up, Mr.
2 Chairman, and Senator Schumer will be joining me in this
3 amendment, is I am going to start the long march of
4 trying to reform the tax breaks as it relates to the oil
5 industry.
6 So in just one of the close to $3 billion of new
7 subsidies that the oil and gas people got a couple of
8 months ago, I am going to propose that that subsidy, just
9 one, be limited to the small producers. That way we are
10 making it clear that we are not talking about something
11 that could hurt some independent, but I have got the
12 figures here, colleagues.
13 In 2003, 2004, 2005, when you look at drilling rigs,
14 when you look at the amount of drilling that is taking
15 place without tax breaks, the President of the United
16 States is right: you do not need these tax breaks when
17 the price is at this level.
18 So I am going to start, and I hope there will be
19 bipartisan support for this, to take just one of the new
20 breaks, the exploration break, and propose that it be
21 confined to the small producer. I hope there will be
22 bipartisan support for it.
23 Thank you, Mr. Chairman.
24 The Chairman. Thank you, Senator Wyden.
25 Now, Senator Lott. Then after that, Senator

1 Rockefeller.

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1 OPENING STATEMENT OF HON. TRENT LOTT, A U.S. SENATOR FROM
2 MISSISSIPPI
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4 Senator Lott. Thank you very much, Mr. Chairman. I
5 appreciate your efforts. I know it is always very
6 difficult. I want to associate my remarks with those of
7 Senator Kyl and Senator Crapo.
8 I guess you know when a tax bill in the Finance
9 Committee is about ready to be reported when it reaches
10 the point where it is almost as bad as it is good. I
11 think that we have achieved that position now, so we are
12 about ready to report this bill.
13 Having said that, I want to talk, first, about the
14 good. I want to thank you, Mr. Chairman, and my
15 colleagues, for continuing to work with us on the Katrina
16 tax package. We need more help there. In fact, the
17 recovery is not going really that well.
18 We really need these tax incentives, so thank you for
19 including it in this legislation. If I can find a way,
20 or if there is another way to put it somewhere else, I
21 would be glad to do that. But we need this help rather
22 desperately, so thank you for giving us a chance here.
23 Second, I do agree with those that are concerned, if
24 we do not do this, there are going to be tax increases.
25 And by the way, tax increases on families and small

1 businesses, people who really need it and are counting on
2 it. So, I think those are two really positive things as
3 to why we do need to do this.
4 I am concerned very much about some things that are
5 not in here. I do think that we ought to have some
6 language in here that deals with the extension of the
7 active financing issue.
8 I do think we should have the provisions in here now
9 that would meet the requirements of Section 355(b) in a
10 way that is better than currently exists. This is
11 something we have done before. I thought we were going
12 to get it done in a mark or on a vote. But I understand
13 now, because of some technicality, maybe it will not be.
14 So, I am concerned about that.
15 I am very concerned that the capital gains and
16 dividends provisions are not in here in any form. So,
17 there are three things that are not in here that really
18 bother me.
19 There are a couple of things that do bother me also
20 that are in there. The IFO revenue raiser. I would say
21 to my colleague from Oregon, I would be interested in his
22 amendment, but be careful that you exclude the
23 independents, the small guys, because this language that
24 is in the bill is not just aimed at the big boys, it hits
25 some of the smaller ones, too. How do I know? They have

1 been calling me.

2 Also, the modified R&D credit. I assume it is just a
3 mistake, the way it is constructed, but it has some
4 negative aspects to it.

5 But, Mr. Chairman, I will support your effort here
6 and I hope we can improve this legislation as we go
7 through the process in the Senate, and certainly I am
8 counting on us having a really good bill that comes out
9 of the eventual conference.

10 Thank you very much.

11 The Chairman. Thank you, Senator.

12 Senator Rockefeller, then Senator Bingaman.

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1 OPENING STATEMENT OF HON. JOHN D. ROCKEFELLER, IV, A U.S.
2 SENATOR FROM WEST VIRGINIA
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4 Senator Rockefeller. Thank you, Mr. Chairman.
5 I guess I am kind of disappointed in the bill that we
6 have before us for a variety of reasons, and I look
7 forward to supporting the Baucus alternative that will
8 provide relief for military families and will deal with
9 some of the problems of hardworking families that do not
10 have much money.
11 It is interesting in this committee, I would say to
12 my colleagues, that this is a very rural committee.
13 There are enormous numbers of people of rather low income
14 or who are struggling to get that income, and even if the
15 income goes above $30,000 or $40,000, you have got
16 children to get into college and all the rest of it and
17 it does not mean very much.
18 We have somehow developed an ethos that if you talk
19 about what the very wealthiest get as opposed to what the
20 poorest get, that you have just fallen into that old
21 mantra of escapism for what really improves your country,
22 which is just enormous tax breaks.
23 Now, I am not sure, and Kent Conrad has already
24 spoken, but I think that people talk about our deficit,
25 which is $300 billion-plus, but it is going to go up.

1 When you talk about the deficit and our fiscal situation,
2 therefore, what my people from my State can look forward
3 to in the future, you cannot just talk about that, you
4 have got to talk about the $650 to $700 billion trade
5 deficit.
6 There is no difference between a budget deficit and a
7 trade deficit. You just add on one to the other and then
8 you add the interest payment on the $7.9 trillion that we
9 now owe and borrow from Japanese and Chinese banks over
10 the years.
11 So it is almost a vulgar storm of financial reality
12 that is going to close in on our people, not just this
13 year, but in the coming years, because we are not going
14 to have the money to carry on.
15 I have erred in what I have told my colleagues before
16 about babies born in West Virginia and who pays for it.
17 In the past, I have said that about 50 percent of all
18 babies who are born in West Virginia are paid for by
19 Medicaid. That is actually not true. It is about 60
20 percent of all babies who are born in West Virginia are
21 paid for by Medicaid.
22 Now, how does one respond to that? One says, well,
23 gee, I guess they do not work hard enough, or something
24 like that. I have lived there for 40 years and I have
25 found that there are very few people who work harder than

1 coal miners, steel miners, and survival farmers. I
2 suspect that Senator Bunning knows what I am talking
3 about. But I find this a stunning abrogation of
4 responsibility and I will leave it at that.
5 The Chairman. Thank you, Senator Rockefeller.
6 Now, Senator Bingaman?
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1 OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR
2 FROM NEW MEXICO
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4 Senator Bingaman. Thank you very much, Mr.
5 Chairman.
6 I will say what I think several have said, and that
7 is that there are a great many provisions in here I
8 support, many of the extensions of current tax provisions
9 I support, and I compliment you for including those.
10 I am, though, extremely concerned about what Senator
11 Snowe referred to as the "fiscal shell game" that we are
12 playing with this legislation, and with the pattern that
13 we have fallen into, we have become the tax extender
14 committee to a very real extent.
15 We have cut taxes in previous years more than we
16 could afford to under the budget resolutions then in
17 effect, and in order to get away with it we put very
18 short time limits on them and said, this is going to
19 expire in a few years.
20 Then when the time for expiration draws near, the
21 drumbeat grows that anybody who does not vote to extend
22 the tax cut is voting to raise taxes, so we cannot do
23 that. So instead of that, we wind up extending the tax
24 cut and adding the cost of extending the tax cut to the
25 debt, and so we get deeper and deeper into debt, as I see

1 it. I think that is the problem I see in the bill before
2 us. That is the problem I see in the years ahead.
3 I think we have got even more of this coming at us in
4 the next few years where there are expirations going to
5 occur and there is going to be a push to extend those
6 provisions and keep the taxes at the levels that they
7 were enacted at, although knowing full well that we
8 cannot afford to do that without just adding it to the
9 debt, and we will be in the same box next year and the
10 year after that we are in this year.
11 So I am very concerned about that same fiscal shell
12 game that the Senator from Maine referred to, and for
13 that reason I do not expect to support the package that
14 is reported by the committee. But I compliment you for
15 many of the specific provisions you have included.
16 Thank you.
17 The Chairman. Thank you.
18 Now, Senator Conrad, then Senator Santorum. Then we
19 will go the mark and explanation of the modification.
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1 OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR
2 FROM NORTH DAKOTA
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4 Senator Conrad. Thank you, Mr. Chairman. I, too,
5 want to congratulate you on putting together a package.
6 Many of the specific provisions, I support. But I
7 believe very strongly this package ought to be paid for,
8 and it is not paid for.
9 Chairman Greenspan said this to us: "We should not be
10 cutting taxes by borrowing." That is precisely what is
11 about to happen here. Every dime of this is going to be
12 borrowed, and that is after the debt increased last year
13 by $551 billion. I know the news accounts all talk about
14 the deficit, something over $300 billion, but the debt of
15 the country increased last year by $551 billion.
16 I would ask my colleagues, at what point are we going
17 to get serious about doing something about this borrow-
18 and-spend policy that has been adopted in Washington? It
19 is clear it is not going to happen under the five years
20 of this budget, because in the five years of this budget,
21 here is what is going to happen to the debt of the
22 country: it is going to go up by at least $500 billion
23 each and every year of this budget. In fact, it is going
24 to average over $600 billion a year. Those are not my
25 calculations, those are the calculations of the people

1 who wrote this budget.

2 Mr. Chairman, the reconciliation process was designed
3 to provide special fast track procedures to reduce the
4 deficit. Now it is being highjacked and used to increase
5 the deficit. That is what is going on here.

6 If you think out there across the country that the
7 goal of Congress ought to be to increase the deficit in
8 the face of these runaway debts, this is the package you
9 should support because it is going to increase the
10 deficit further.

11 Look, we have had, in the past, what is called "pay-
12 go." I strongly support it. Most members around this
13 table, or at least many, have supported it in the past.
14 It says you can have additional tax cuts if you pay for
15 them. You can have additional spending if you pay for
16 it. But that is not what is happening here.

17 Instead, we are having more tax cuts that are not
18 paid for, that deepen the deficit, that add to the debt
19 when we already have a runaway debt. Over the last five
20 years now, the foreign holdings of U.S. debt have
21 increased by more than 100 percent. Is anybody paying
22 attention? Does anyone care?

23 The debt held by foreigners has gone up 100 percent
24 in five years. It took 224 years to run up a trillion
25 dollars of debt; we have doubled it in five. I will

1 offer a substitute to pay for these provisions.

2 I thank the Chair.

3 The Chairman. Thank you.

4 Senator Santorum?

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1 OPENING STATEMENT OF HON. RICK SANTORUM, A U.S. SENATOR
2 FROM PENNSYLVANIA
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4 Senator Santorum. Thank you, Mr. Chairman.
5 Before I comment about the substance of the bill, let
6 me just comment that I hear lots of complaining about
7 fiscal irresponsibility and about the size of deficit
8 when it comes to letting people keep their hard-earned
9 dollars.
10 I do not hear those same types of comments, nor do I
11 see the votes put up on the floor of the Senate, when it
12 comes to spending their hard-earned dollars. There,
13 deficits do not seem to matter as much. They only matter
14 when it comes to letting people keep their money, not
15 when we decide how to best spend their money.
16 I know Chairman Greenspan said we should not be
17 growing government by borrowing, but I guarantee you, I
18 can find a whole host of quotes which say we should not
19 be growing government by borrowing, which is what is
20 repeatedly voted for by members on the other side of the
21 aisle.
22 So, I think that if we are going to be consistent
23 about deficits, then our votes have to reflect that, both
24 when it comes to spending money, as well as letting
25 people keep their hard-earned dollars.

1 Mr. Chairman, this is an important piece of
2 legislation and I commend you for the work that you are
3 doing in extending these tax provisions. I like to refer
4 to this bill as the Tax Increase Prevention Act.
5 But for this bill, almost 400,000 Pennsylvanians will
6 see their taxes go up, and go up, in some cases,
7 dramatically because of the Alternative Minimum Tax. We
8 are number two in the country, behind New York State, in
9 the number of taxpayers who pay the AMT.
10 There are a whole host of other provisions in here
11 that would otherwise be expiring that are important for
12 the growth of this economy, including, as my colleagues
13 have mentioned, the capital gains and dividends
14 provisions.
15 The Work Opportunities Tax Credit. I want to thank
16 you, Mr. Chairman, for including that, and for the
17 reforms of the Work Opportunities Tax Credit, which are
18 important for low-income people to be able to get good-
19 paying jobs.
20 Your inclusion of some changes in the brown fields
21 legislation, the tax treatment for sites that are stained
22 by petroleum, is also important to my State, and I
23 appreciate where oil was first founded in this country.
24 For my State, that is very important and I appreciate
25 your addition.

1 Finally, I want to thank you for including many
2 elements of the charitable giving bill that Senator
3 Lieberman and I have been working on for the past several
4 years. I will have some comments about some other
5 provisions in the charitable area, but I certainly
6 appreciate the work that you have done in giving
7 incentives for taxpayers to give more to charities, those
8 who are out there, as we saw, on the front lines during
9 Katrina who were responding to the need more effectively
10 and efficiently than any government agency. We saw that
11 on display in Katrina.
12 What we do not see every day, is these organizations
13 that are out there in the neighborhoods of America,
14 meeting needs and doing things much better than any of us
15 could have ever hoped to with a government agency, and
16 now we are providing resources to them. So, I thank you,
17 Mr. Chairman.
18 The Chairman. Yes. And thank you for your history
19 lesson on oil. I assume you know the year was 1859.
20 Senator Santorum. The Drake well. Yes, sir.
21 The Chairman. Mrs. Lincoln, you are the last person
22 to speak now, if you want to speak. But you do not have
23 to. [Laughter].
24 Senator Lincoln. Well, I will be brief. How is
25 that?

1 The Chairman. Well, we have got a buzzer to make
2 sure.
3 Senator Lincoln. That is right.
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1 OPENING STATEMENT OF HON. BLANCHE L. LINCOLN, A U.S.
2 SENATOR FROM ARKANSAS
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4 Senator Lincoln. Well, thank you, Mr. Chairman.
5 Thank you for your hard work and diligence in bringing us
6 here today.
7 In light of the current challenges that we face as a
8 Nation--Katrina, Rita, our Federal Government's deficit,
9 and all of the many issues that we face--it is certainly
10 our responsibility to manage our Nation's budget and to
11 do it in a fiscally responsible way, but also in a way
12 that can be, I think, looked at as growing the economy
13 and making sure that we can continue to maintain
14 ourselves as the strongest Nation on the face of this
15 earth.
16 But we do face hard times, Mr. Chairman. Americans
17 can always be counted on when we do face hard times,
18 however, to do two things: we take care of one another,
19 and we know that we have to make sacrifices.
20 I think in the Congress here we worked through the
21 budget reconciliation process, and as we do I think it is
22 so imperative that we remember these rules.
23 We have to find the right equations that ensure we
24 take care of those who are relying on their country so
25 much right now. I have spoken, really until I am blue in

1 the face, about my neighbors in the Gulf region, about
2 the needs, the devastation that has existed, the fact
3 that they do need our help.
4 They need their American family to reach out and
5 recognize that it is not only the immediate needs that
6 they have, but the ability to rebuild their homes and
7 their communities is so essential.
8 Katrina victims, those living in poverty, the high
9 cots of health care, all of which exists right now, both
10 in the Gulf Coast and other areas of our Nation. We have
11 to make sure that we all share in the sacrifices that
12 might result.
13 So I think that as we look at what the Chairman has
14 brought together here, I am pleased with many of the
15 steps that you have taken, Mr. Chairman. I think average
16 Americans sit down at the kitchen table to do their
17 family budgets and they work to ensure that it is
18 balanced, that it meets their family's basic needs before
19 they splurge on expenses that either are not immediate or
20 just simply are not necessary at the moment, and it looks
21 as if you have brought about that compromise here, and I
22 am pleased to see that.
23 So, I look forward to the rest of the mark-up. I
24 want to thank my colleague, Senator Smith from Oregon,
25 for his efforts on the private mortgage insurance

1 deduction.

2 I think that is really important in terms of growth,

3 certainly the R&D credit, as well as the saver's credit,

4 and without a doubt, Mr. Chairman, the work on the AMT

5 relief, which I think is so needed among many of our

6 American families.

7 So I thank you, Mr. Chairman, and look forward to

8 moving through the mark-up.

9 The Chairman. Yes. When Senator Schumer is done in

10 three minutes from now, I am going to then call up the

11 bill that is before us, call up the modification. Mr.

12 Yin, you would explain the modification. I would ask

13 you, since people want to have a chance to ask questions,

14 to summarize as much as you can.

15 Senator Schumer?

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1 OPENING STATEMENT OF HON. CHUCK SCHUMER, A U.S. SENATOR
2 FROM NEW YORK
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4 Senator Schumer. Well, thank you, Mr. Chairman.
5 First, I want to thank you for your efforts here. As
6 usual, you are trying to work this in a bipartisan way.
7 I think that the bill before us is considerably better
8 than what many of us on this side of the aisle had
9 feared. We still have a ways to go.
10 My great worry is, I hope this is not the high point,
11 and that as we move through the process, particularly
12 conference, and it comes back, things get considerably
13 worse, both in terms of deficit reduction and in terms of
14 fairness.
15 I hope that we can keep this bill the kind of bill it
16 is now, a bill that will have some bipartisan support, a
17 bill that will sort of be a moderate centrist bill. I
18 know that the temptation is in each party to sort of go
19 to the extreme wing, but that does not really serve the
20 public well and serve the committee well.
21 A couple of things I care about a great deal that are
22 in this bill: the continuation of tuition deductibility,
23 something that helps middle class families go to college.
24 I have worked with Senator Snowe on that previously and
25 that is extended. The importance of reducing the AMT, a

1 great burden to the people here in New York.

2 And, Mr. Chairman, I want to thank you, in part, for

3 your willingness to understand the particular needs that

4 my area has in terms of switching, in terms of the $20

5 billion, the money that we did not use for tax

6 expenditures, to go into transportation.

7 Senator Baucus. Two billion.

8 Senator Schumer. Two billion. Yes. No, I was not

9 trying to get $20 billion. Out of the original $20

10 billion, the $2 billion was not used, and this is a

11 promise that the President and others have made that we

12 are following through here.

13 So it is my hope that we can stay the course, that

14 this kind of bill, which is a moderate bill that does a

15 whole lot of good, does not get transmogrified into

16 something as it goes through the process that will make

17 deficits worse and make it less fair, if you will, to the

18 average middle class American who this bill does try to

19 look out for in a whole lot of ways.

20 Thank you, Mr. Chairman.

21 The Chairman. Thank you, Senator Schumer.

22 Now, as I announced, I will go to Mr. Yin. This will

23 be on the modification, right? Proceed.

24 Mr. Yin. That is correct, Mr. Chairman.

25 For the members of the committee, I am going to be

1 working off of the JCX document which describes the
2 Chairman's modification. It is JCX-77-05, if you would
3 like to follow along. I am going to be simply, very
4 briefly, summarizing the highlights of the modification.
5 The first item I will mention is A-4, which is on
6 page 3 of the document I referenced. What this provision
7 does, is it modifies the extension of the AMT exemption
8 amount in 2006 to be indexed for inflation.
9 What this will do, will be to increase the exemption
10 amount in 2006 by $14,600 for joint filers and $7,600 for
11 individual filers, so that the total exemption in 2006
12 will e $59,600 for joint filers and $41,350 for
13 individual filers.
14 Senator Baucus. If I might, Mr. Chairman, ask on
15 that point.
16 The Chairman. Yes.
17 Senator Baucus. Mr. Yin, as I understand it, today
18 about 3 million Americans pay AMT. As a consequence of
19 this change, it is my understanding that more Americans
20 will be paying AMT. Is that correct?
21 Mr. Yin. That is correct, Senator Baucus.
22 Currently, in 2005, about 3.6 million people pay the AMT.
23 That will go up, even with this increase, to about 4.2
24 million in 2006.
25 Senator Baucus. Correct. Now, how much does it

1 cost to make sure that no more than 3 million pay?

2 Mr. Yin. I do not have the number off the top of my

3 head. I think it is roughly in the range of another $2

4 billion or so over five years.

5 Senator Baucus. Two billion. So in this bill, over

6 a five-year period, how much would that be?

7 Mr. Yin. Well, over five years it would be $2

8 billion.

9 Senator Baucus. Two billion over five years.

10 Mr. Yin. Because it is simply a one-year extension.

11 Senator Baucus. I see.

12 Mr. Yin. So all of the money would be in the first

13 five years.

14 Senator Baucus. Thank you. But again, in this

15 bill, how much does AMT cost? What is allocated for AMT

16 in the modified mark?

17 Mr. Yin. As modified, the cost, I believe, is $28

18 billion, maybe $28.5 billion, over five years.

19 Senator Baucus. I am just asking, how much more

20 revenue must we come up with to hold people truly

21 harmless, that is, no more people pay?

22 Mr. Yin. Above and beyond the amount that is

23 already in the modification?

24 Senator Baucus. Yes.

25 Mr. Yin. Well, as I said, I think it is about $2

1 billion additional over five years.

2 Senator Baucus. Additional. Thank you.

3 Mr. Yin. The second item I will mention is item

4 number A-5, which is also on page 3, which strikes the

5 special rule in the Chairman's mark for allowing certain

6 taxpayers to use, in 2005, for their computation of their

7 Earned Income Credit and Child Credit, taxpayers affected

8 by Hurricanes Rita and Wilma, to be calculated using

9 their 2004 earned income.

10 The next item is item A-7, which also is on page 3,

11 which strikes the extension in the Chairman's mark,

12 through 2009, of the reduced rates for dividends and

13 capital gains.

14 The next item is number A-8, also on page 3, which

15 makes several modifications to the Chairman's mark's

16 extension of the Research Credit. This modification

17 would increase the rates of the Alternative Incremental

18 Credit, would allow an Alternative Simplified Credit,

19 generally for expenses --

20 Senator Baucus. I am sorry. I am looking on page 3

21 and I do not know where you are.

22 Mr. Yin. I am looking at item number 8 on page 3,

23 which is entitled, "Modification Relating to the Research

24 Credit."

25 Senator Baucus. Oh. You are on a different

1 document. I am sorry.

2 Mr. Yin. I am sorry, Senator. It is JCX-77-05 and
3 it is entitled, "Description of the Chairman's
4 Modification to the Provisions of the Tax Relief Act of
5 2005."

6 Senator Baucus. Thank you.

7 Mr. Yin. Again, the Chairman's modification would
8 make several changes to the Chairman's mark which extends
9 the Research Credit for one year. The Chairman's
10 modification would increase rates of the Alternative
11 Incremental Credit, allow an Alternative Simplified
12 Credit, generally for expenses exceeding 50 percent of
13 the average qualified expenses over the prior three
14 years, exclude from the credit most research pursuant to
15 a government contract, and also eliminate the rule in the
16 Chairman's mark requiring that Research Credit amounts
17 earned in 2006 not be taken into account for purposes of
18 their estimated tax payments in 2006.

19 I am going to turn now to Section B of the Chairman's
20 modification which is entitled, "Additional Provisions."
21 This begins on page 6.

22 The first 19 of these relate to the charitable giving
23 package and certain related items, and I am just going to
24 summarize some of the highlights of these, and then I
25 will end with a few highlights of the remaining

1 provisions in this section.

2 The first item is item B-1, which is on page 6, which
3 allows non-itemizers to claim the charitable contribution
4 deduction for cash contributions in excess of $500 for a
5 joint filer, $250 for individual filers. It would also
6 add the same floor for itemizers, but they, of course,
7 can deduct both their cash and non-cash contributions.
8 This would be a two-year provision.

9 Item B-2 allows tax-free distributions from IRAs that
10 are made to certain charities or certain split interest
11 entities such as a charitable remainder trust. This is
12 also a two-year provision.

13 Item B-3, which is on page 15, allows non-C
14 corporations to get the enhanced deduction for certain
15 food inventory contributions that currently are available
16 only to C corporations.

17 Senator Baucus. Mr. Chairman? I am sorry. This is
18 a little confusing here.

19 The Chairman. Senator Baucus?

20 Senator Baucus. I am sorry. Senator Hatch made
21 reference, I think, to a provision which also bothers me.
22 Maybe it was Senator Lott. It was on R&D tax credit
23 enhancement provisions not applying to government
24 contractors.

25 I am told that taking government contractors out is

1 part of the modified mark, but I am informally informed
2 that now that is back in. So, I would just like to know
3 where that is at this moment.
4 Mr. Yin. My understanding is that the Chairman's
5 modification does exclude funded research from government
6 contracts as eligible for the R&D credit.
7 Senator Baucus. All right.
8 Mr. Chairman, at an appropriate point I have got some
9 remarks to make on that point. I do not think it is fair
10 to exclude government contractors.
11 The Chairman. All right.
12 Senator Baucus. But that is the same point I think
13 Senator Lott was referring to.
14 The Chairman. All right. We will let you make your
15 point when you want to.
16 Senator Baucus. Thank you. Thank you.
17 The Chairman. Professor Yin, go ahead.
18 Mr. Yin. Thank you, Senator.
19 The next item is item B-4, which is on page 17. This
20 provision treats contributions by an S corporation, the
21 pass-through of that to the shareholders, results in a
22 basis reduction equal to the shareholders' pro rata share
23 of the corporation's basis and the property contributed.
24 The next item is item B-7, which is on page 24. This
25 provision increases the enhanced deduction of

1 contributions of book inventories by C corporations to
2 equal the lesser of fair market value, or twice basis.
3 The next provision is B-8, which begins on page 25.
4 This provision imposes a penalty on most exempt entities
5 for participating in listed or certain reportable tax
6 shelter transactions. The penalty would equal 100
7 percent of the exempt organization's net income from the
8 transaction.
9 The next item is item B-9, which begins on page 30.
10 This provision would impose a 100 percent excise tax on
11 the acquisition costs on taxable acquisitions of any
12 interest in any life insurance, annuity, or endowment
13 contract in which both a tax-exempt organization, or any
14 other person, have directly or indirectly held an
15 interest. This would be effective for contracts issued
16 after May 3, 2005.
17 The next provision is item B-10, which begins on page
18 35. This provision would increase a number of excise
19 taxes that already exist under current law. It would
20 increase the rates of tax and increase the dollar caps
21 currently applicable to certain transactions of private
22 foundations, public charities, and social welfare
23 organizations.
24 The proposal does not change the current structure of
25 any taxes or introduce any new taxes on any person or any

1 transaction that is not already currently subject to tax
2 under present law.
3 The next provision is item B-11, which begins on page
4 40. This provision would limit certain types of
5 organizations that may receive deductible contributions
6 from maintenance in a donor-advised fund and imposes
7 requirements on the manner and amount of distributions
8 that must be made from a donor-advised fund to a charity.
9 The next provision is item B-12, which begins on page
10 51.
11 Senator Rockefeller. Mr. Chairman, am I allowed to
12 ask a question?
13 The Chairman. Yes, Senator Rockefeller?
14 Senator Rockefeller. I have been scrambling amongst
15 the various bulks of material that we have and I would
16 just like to ask you a question, Mr. Yin. When was it
17 that our staffs, A, and we as Senators, number two, had
18 any of this material available to us?
19 Mr. Yin. My understanding is that it was circulated
20 last night, Senator.
21 Senator Rockefeller. Fairly late last night, is my
22 understanding. I am interested in this going through,
23 mostly because I want to keep up with your page count.
24 But you do understand that most people at this table,
25 with some exceptions, obviously, do not know what you are

1 talking about because they are scrambling to find out
2 where you are, and then you move rather quickly on to the
3 next issue.
4 Now, why do I raise that? To be as pleasant as I
5 always am? No, it is simply, again, a matter of process.
6 This is an imperfect storm and it is a process which is
7 achieved through negotiation, but we have all the
8 explanation and the works, the consequences of which are
9 going to be felt for years and years to come, and we are
10 fundamentally listening to you, and listening to you with
11 respect, and probably not understanding a great deal.
12 The Chairman. Senator Rockefeller, he is right when
13 he said that the paper was distributed last night. But
14 there was, yesterday during the day, presentation made to
15 all the staff on what the Professor is discussing now
16 that is in the modification.
17 Proceed, Mr. Yin.
18 Mr. Yin. Thank you, Mr. Chairman.
19 The next item is item B-12, which begins on page 51.
20 This provision prohibits certain transactions with
21 substantial contributors of a support organization, and
22 also imposes pay-out and other requirements on Type 3
23 support organizations.
24 The next item is item B-13, which begins on page 62.
25 This provision limits the conservation deduction for

1 property located in registered historic districts to
2 certain buildings, and any qualifying contribution that
3 relates to the exterior of such a building must preserve
4 the entire exterior of the building.
5 Senator Santorum. Mr. Chairman?
6 The Chairman. Senator Santorum?
7 Senator Santorum. Thank you, Mr. Chairman. I just
8 have a few questions about that provision, hopefully that
9 Mr. Yin will be able to clarify.
10 I understand that this provision includes a mandatory
11 accreditation program to be operated by the National
12 Trust for Historic Preservation. My staff, in some of
13 our meetings today, has informed me that the National
14 Trust has told us that they are not prepared or capable
15 of doing this job.
16 As such, I would recommend that we remove the
17 accreditation provisions from this proposal and replace
18 it with a written agreement between the parties
19 certifying that the qualifying charity is a publicly
20 supported 501(c)(3) or a supporting organization with the
21 purpose of environmental protection, land conservation,
22 open space preservation, or historic preservation, and a
23 commitment that they have the resources to manage and
24 enforce the restrictions of the donation.
25 Additionally, I have concerns that the term

1 "habitable structures" prohibits easements related to
2 historic barns and other rural landmarks. I ask that
3 these structures are included.
4 Lastly, I am very worried about the impact of back
5 dating the effective date to December 16, 2004. While I
6 understand this is the date that the Chairman raised
7 these concerns, we should not arbitrarily be denying
8 these deductions because of that. I would ask that we
9 modify the effective date as a result.
10 The Chairman. Your question is to Mr. Yin for
11 explanation or the possibility of doing that? That is a
12 policy decision that the committee would have to make.
13 Senator Santorum. Maybe Mr. Zerbe can address the
14 issues.
15 Mr. Zerbe. The statement that Senator Santorum gave
16 us, we find we are in agreement with the Senator and
17 would ask that you agree to it, I think, with one
18 clarification that we would like, that the effective date
19 for deductions to date of enactment, but keep the
20 penalties for appraisals to the original date.
21 The Chairman. As Chairman of the committee, let me
22 raise a question.
23 Mr. Zerbe. Yes, sir.
24 The Chairman. I thought, historically, for any
25 Chairman of this committee or Chairman of the Ways and

1 Means Committee, there was great respect when we said
2 there was abuse of the Tax Code or something that we
3 wanted to change in the Tax Code and went into effect on
4 a certain date, that that is what we have traditionally
5 done.
6 Mr. Zerbe. Yes, Mr. Chairman. We are going to do
7 that, I think, with the understanding --
8 The Chairman. Well, he is objecting to it.
9 Mr. Zerbe. No, Senator. It is a different way of
10 accomplishing it, in terms of ensuring that those who
11 were found to have done abusive transactions will be
12 subject to more significant penalty structures, which is
13 what we believe you and Senator Baucus had agreed to.
14 But what Senator Santorum is concerned about, is the
15 limitations on what a facade is, basically what an
16 easement can constitute, would start effective as of
17 today.
18 The Chairman. All right.
19 Senator Santorum. Thank you, Mr. Chairman. I
20 appreciate it.
21 The Chairman. Proceed, Mr. Yin.
22 Mr. Yin. Thank you, Mr. Chairman.
23 The next item I will describe is item B-15, which
24 begins on page 70, relating to clothing and household
25 items. This provision provides that the IRS must provide

1 an itemized list of the maximum contribution amount for
2 items that are considered "in good, used condition," with
3 the deduction for items in lesser condition equal to 20
4 percent of the value that is listed in the IRS list, and
5 certain types of properties excluded from this provision.
6 Now I am going to just relate a couple of the
7 highlights of the remaining provisions outside of the
8 charitable giving area. Item B-23, which begins on page
9 95, makes a modification to the individual estimated tax
10 safe harbor.
11 Under the proposal, taxpayers with an adjusted gross
12 income over $150,000 in 2005 will be required to make
13 their 2006 estimated tax payments based on the lesser of
14 90 percent of their 2006 income tax liability and 119
15 percent of their 2005 income tax liability.
16 Item B-24, which begins on page 96, relates to
17 corporate estimated tax payments. This proposal permits
18 corporate taxpayers to pay, on October 1, 2010, 3 percent
19 of their estimated tax payments ordinarily due on
20 September 15, 2010.
21 The next item is item B-26, which begins on page 98.
22 This relates to the Hope and Lifetime Learning Credits,
23 and would generally double the amount of the Hope and
24 Lifetime Learning Credits for 205 and 2006 for students
25 who are enrolled and paying tuition at eligible

1 educational institutions in the Gulf recovery zone.

2 The next item is item B-27, which begins on page 103.

3 This relates to the New York Liberty Zone tax incentives.

4 The proposal generally repeals any remaining Liberty Zone

5 tax benefits and instead provides any governmental unit

6 of New York State, as well as New York City, together

7 with an annual tax credit of up to approximately $200

8 million, with a maximum total credit of $2 billion, which

9 would relate to transportation infrastructure needs in,

10 or connecting to, the New York Liberty Zone.

11 The last item I will mention is item B-29, which

12 begins on page 109. This relates to LIFO inventories of

13 large, integrated oil companies. This provision would

14 increase the taxable income of integrated oil companies

15 with gross receipts over $1 billion by, in effect,

16 disallowing 75 percent of the tax benefit they would

17 otherwise obtain from using the LIFO method of accounting

18 in 2005. The disallowed benefit would be spread among

19 the remaining LIFO layers of the company.

20 Mr. Chairman, that concludes my description of the

21 Chairman's modification.

22 Senator Wyden. Mr. Chairman? Mr. Chairman?

23 The Chairman. Just a minute. We are ready for

24 questions. We have had some questions, but if there are

25 more questions we will entertain those in the order that

1 you seek recognition.

2 So, Senator Wyden, then Senator Bingaman.

3 Senator Wyden. Mr. Chairman, if I could ask Mr.
4 Yin, on that LIFO provision at page 109, does that last
5 for just one year?

6 Mr. Yin. It is a provision that is only applicable
7 to 2005. That is correct.

8 Senator Wyden. Thank you, Mr. Chairman.

9 The Chairman. All right.

10 Senator Lott. Mr. Chairman?

11 The Chairman. I have got to take them in order as
12 they request recognition.

13 Senator Bingaman, then Senator Rockefeller, then
14 Senator Lott.

15 Senator Bingaman. Thank you very much.

16 Mr. Yin, I just wanted to have a short explanation on
17 item 24, over on page 96, the time for payment of
18 corporate estimated taxes in 2010. We are putting that
19 off by one day in order to kick those additional revenues
20 into the next fiscal year, I gather. But what is the
21 underlying cause for that? Why is it important for us to
22 not allow those revenues to come in as they would
23 otherwise come in?

24 Mr. Yin. As I understand it, Senator, the objective
25 of the Chairman's modification was to reach a revenue

1 loss figure of $60 billion in the first five years. What
2 this provision does, would be to take approximately $1
3 billion of additional revenue loss in 2010 within the
4 five years, and therefore reduce $1 billion of revenue
5 loss in 2011.
6 Senator Bingaman. So they would have an additional
7 billion dollars of revenue loss in the five-year period
8 if we did not make this change.
9 Mr. Yin. No, it is just the opposite. If we did
10 not make this change we would have one billion dollars
11 less revenue loss in the five-year revenue. It would be
12 about $59 billion of revenue loss.
13 Senator Bingaman. That would be a good thing,
14 right? I mean, I thought we were trying to minimize the
15 revenue loss.
16 Mr. Yin. Well, just to clarify, Senator Bingaman,
17 this provision does not change the amount of revenue loss
18 over the 10-year period, it simply allocates it slightly
19 differently within those two five-year windows. But over
20 10 years, this provision has no revenue effect
21 whatsoever.
22 Senator Bingaman. Right. Thank you, Mr. Chairman.
23 The Chairman. Now, Senator Rockefeller, then
24 Senator Lott.
25 Senator Rockefeller. Mr. Chairman, you know that I

1 have the greatest respect for you. It is not a cliche,
2 you know it absolutely, just as the Omaha paper knows
3 that I have the greatest respect for you, because I have
4 said so.
5 The Chairman. I made a point of reading it.
6 Senator Rockefeller. Yes. And I want to just get
7 back to the process question, because I really believe in
8 process, Mr. Yin, when it comes to doing something like
9 this.
10 The Chairman indicated a moment ago, when I
11 mentioned, when did this all become available, and he
12 said there was a staff briefing. The staff briefing,
13 from what I can determine, lasted, at the maximum, 30
14 minutes and was highly cursory, unless you would dispute
15 that.
16 Second, this material that we are looking at, with
17 our educated and absorbing abilities, was not actually
18 made available until midnight of last night.
19 Are either of those statements correct?
20 Mr. Yin. As to the second point, it was very late
21 last night and it could well have been towards midnight.
22 I believe it was before midnight, but I do not know
23 exactly when the Finance Committee staff circulated it,
24 so I do not know for sure.
25 Senator Rockefeller. And I totally understand the

1 pressures that the Chairman was under and they were
2 meeting all day yesterday, and we thought we were going
3 to meet and we did not, so we are meeting now.
4 But is there not something fundamentally important
5 when we rearrange, to a certain extent, the taxing
6 situation in this country, as Senator Conrad has pointed
7 out, that we add enormously to the deficit, whereas I
8 would point out we cut billions out of Medicaid, just as
9 governors are reaching for Medicaid waivers which will do
10 things which I do not even want to contemplate, and
11 having them approved, is it not important that we have a
12 chance to talk about this? Or is this a satisfactory
13 circumstance to you, as a professional? Would you go to
14 a meeting with the amount of time that we have had to
15 look at this in order to defend your position?
16 The Chairman. Are you not putting the Professor in
17 a pretty impossible situation.
18 Senator Rockefeller. I am. But he is amenable.
19 [Laughter].
20 The Chairman. All right. Mr. Yin, you will not
21 offend me if you answer in any way you want to answer.
22 Mr. Yin. Thank you, Mr. Chairman. I think, in the
23 ideal, everyone would benefit from a greater amount of
24 time. These matters are difficult to understand for even
25 the most skilled professional.

1 Senator Rockefeller. I thank you, and I thank the
2 Chairman.
3 The Chairman. Senator Rockefeller, before I go to
4 Senator Lott, if you would let me just counteract, to
5 some extent, because I did not take offense to anything
6 you said.
7 But just as an example, with some history, we got in
8 the morning of whatever date it was in 1993, the morning,
9 the mark that ended up being the 1993 tax bill, as just
10 one example. The other example is, we have had several
11 hearings on this issue of charitable giving and abuses.
12 Also, I believe, at least at the staff level, but
13 sometimes Senator Baucus and I talking about it, we have
14 been very transparent over a long period of time on the
15 whole issue of abuse. I am not saying that we would
16 agree on everything.
17 Most of what we are doing today, maybe it is not as
18 partisan as it would be if it had capital gains in it,
19 but it is still somewhat partisan because you will have
20 an alternative. This part, to me, has not been partisan
21 at all, this issue that we are dealing with here.
22 Senator Rockefeller. No, Mr. Chairman. I would
23 agree with you. I think Senator Santorum and I are both
24 on the same side on this issue and we both fought for
25 fair treatment of eleemosynary institutions, provided

1 they follow the law. I am simply setting it as this sort
2 of large collection that we have. It is not on this
3 subject alone. I appreciate the Chairman's response, and
4 I have made my point.
5 The Chairman. Senator Lott?
6 Senator Lott. Thank you, Mr. Chairman.
7 Two questions of you, Mr. Yin. There were several
8 provisions that wound up in this mark that surprised me.
9 One of them was the provision with regard to the LIFO.
10 You indicated that there would be an exemption for small,
11 independent people of $1 billion.
12 Was there any scientific basis for that? Is there
13 any kind of usual rule for what is considered small and
14 independent? Because from what I understand, this $1
15 billion level catches an awful lot of small and
16 independent types that I assume was not the intent.
17 Mr. Yin. Senator Lott, let me clarify that there
18 really are two conditions to be subject to the rule.
19 One, is the company would have to be an integrated oil
20 company. That is a defined term in the statute.
21 As you know, integrated oil companies, for example,
22 are not entitled to the percentage depletion allowance,
23 but independents are. That definition is in Section 291
24 of the Code. So, only integrateds are subject to the
25 provisions. Then in addition to that, only integrateds

1 with gross receipts in excess of $1 billion.
2 Senator Lott. Was there any scientific basis for
3 the $1 billion? It seemed like an awfully nice, round
4 figure.
5 Mr. Yin. To my knowledge, there was not any
6 scientific basis, other than an attempt to --
7 Senator Lott. Would this limitation on the LIFO
8 provisions apply or does the Code prohibit it from any
9 other sector of the economy?
10 Mr. Yin. This provision would only apply to
11 integrated oil companies with gross receipts in excess of
12 $1 billion.
13 Senator Lott. With regard to the R&D tax credit
14 where you added the additional provision prohibiting
15 taking the R&D credit on fixed-price contracts in which
16 the contractor bears the risk of performance, what is the
17 revenue cost associated with this aspect of the proposal?
18 Do you have a number on that? I mean, I am assuming this
19 was done to raise revenue, because I do not think it
20 makes good policy sense.
21 Mr. Yin. Again, if you are referring to the
22 government funding provision, I believe it is
23 approximately $600 million over five years.
24 Senator Lott. So it is projected that, by that
25 additional change, it would raise $600 million?

1 Mr. Yin. It reduced the costs of the provision by
2 about $600 million over five years. That is correct.
3 Senator Lott. Thank you, Mr. Chairman.
4 The Chairman. Thank you.
5 Now, Senator Thomas?
6 Senator Thomas. Thank you, Mr. Chairman.
7 I want to refer to number 29, the LIFO inventory
8 thing. This fund raiser would undermine a longstanding
9 accounting principle that has been used universally, for
10 some 30 years, as a matter of fact. So it is a one-time
11 retroactive, designed temporarily. Other industries
12 would continue to go on as they have.
13 It is sort of interesting to me that we have worked
14 all these years and finally came up with an energy
15 incentive program, and you keep talking about all these
16 deficits and so on, and how would you all like to be in a
17 place where there is no energy for us to be able to
18 operate our economy? When you think about a deficit, you
19 would have a deficit then.
20 So it seems to me we are undermining the energy
21 policy that we just worked on for several years. Why
22 have you selected out just this one group? I suppose it
23 is because you had the hearing and found out that energy
24 companies were making some money. Is that what is
25 causing it?

1 Mr. Yin. I am simply describing the Chairman's
2 proposal. [Laughter].
3 Senator Thomas. Well, I wish someone would describe
4 to me why we do this to counteract the policy that we
5 have been working on all this time. Now, I understand
6 there are some underlying problems here.
7 I just do not understand this. I guess it is to
8 offset trying to tax the energy companies to get back
9 some of the money. This is not the place to do that.
10 Here we are, trying to get an energy policy to get more
11 energy for this country. At any rate, I cannot
12 understand it.
13 Senator Hatch. Will you yield to me for a second?
14 Senator Thomas. Certainly.
15 Senator Hatch. One of the things we did in the
16 energy bill, was we put in the potential of not only oil
17 shale and tar sands, but geothermal, refining language
18 with incentives. We have lost 200 refineries over the
19 last 35 years, and have only built one. Now we are
20 adding, because we cannot get a windfall profits tax, it
21 seems to me. I know that that is not your decision.
22 The Chairman. I would suggest that this is all
23 about embarrassing Grassley.
24 Senator Bunning?
25 Senator Hatch. No, it is not. It certainly is not.

1 Senator Bunning. Far be it for me to try to
2 embarrass Senator Grassley.
3 I support my friend from Wyoming. The energy bill
4 that I was fortunate enough to assist in writing, along
5 with the Senator from Wyoming, contains some very
6 important provisions to encourage the development of new
7 refineries here in America.
8 There is a compelling need to develop new
9 infrastructure to keep prices low and diversified from
10 the concentration of facilities in the Gulf of Mexico.
11 Moving away from the LIFO tax treatment of oil could
12 generate a one-time multi-billion dollar tax penalty on
13 the refining and marketing industry.
14 We cannot just penalize these companies with an
15 accounting gimmick just as we are trying to convince them
16 to invest billions of dollars in new facilities. The
17 Internal Revenue Code has, for 70 years--70 years--
18 accepted LIFO as the best reflection of a taxpayer's
19 income.
20 This is not some loophole that the oil industry has
21 used. All taxpayers with inventories can elect to use
22 LIFO. It would be unfair to impose FIFO standards on
23 only one industry and would set a dangerous tax
24 precedent. Thank you.
25 The Chairman. Are there further questions now? Or

1 we will go to amendment. [No response]. Then I would
2 offer the first amendment. I have to ask my staff to
3 give me the number of this amendment.
4 Senator Baucus. Mr. Chairman, before you do.
5 The Chairman. Yes, go ahead.
6 Senator Baucus. This might be an appropriate time
7 to make a fairly important statement.
8 The Chairman. Go ahead.
9 Senator Baucus. Which is, I believe this is the
10 last appearance of George Yin before this committee. I
11 think he has done a masterful job. I do not know how
12 George does it, with all the pressures he gets from all
13 different directions. He keeps his cool, his
14 professionalism. He is so terribly competent, and I
15 think this committee owes George a big round of applause
16 for all his work.
17 [Applause].
18 Mr. Yin. Thank you all very much. Let me just say
19 what a privilege it has been to serve on the Joint
20 Committee and to serve Congress and this committee.
21 Also, I would like to express my gratitude for the
22 tremendous help I have had from my staff throughout my
23 tenure here.
24 The Chairman. Thank you.
25 Senator Baucus. Thank you. You bet.

1 The Chairman. The reason this amendment I was going
2 to refer to does not have a number, is because it is an
3 amendment to my modification. The provision that
4 previously passed the committee and the full Senate in
5 the Care Act cost several billion dollars.
6 Placing a floor on both itemizers and non-itemizers
7 the cost of this provision, which increases charitable
8 giving by providing incentives to 74 percent of the
9 taxpayers who currently get no tax benefit for their
10 charitable contributions.
11 This provides equality among taxpayers with respect
12 to the deduction for charitable contributions. It is
13 also in keeping with the Tax Reform Panel's
14 recommendations on charitable deductions. Most
15 importantly, the charitable community supports this
16 provision.
17 That being said, I understand that there are some
18 concerns regarding the amount of revenue raised by this
19 provision. My staff received numbers late last night and
20 were also surprised.
21 As a result, I offer an amendment to the modification
22 to lower the floor proposed in the Chairman's mark from
23 $250 to $210 for individuals, and from $500 to $410 for
24 married taxpayers. Reducing the floor in this manner
25 costs $2 million over five years.

1 Senator Bunning. Two billion or two million?
2 The Chairman. Million.
3 Senator Santorum. Mr. Chairman?
4 The Chairman. Senator Santorum?
5 Senator Santorum. Mr. Chairman, I thank you for
6 that modification. It is appropriate. As you said, by
7 making the changes between itemizer and non-itemizer,
8 this will encourage--dramatically encourage--charitable
9 giving to three-quarters of Americans who get no benefit
10 from giving charitable deductions.
11 If you look at who the itemizers are, this will not
12 have any significant impact on charitable giving for
13 itemizers. So, I greatly appreciate the work that you
14 have done on this.
15 The Chairman. Let me see. Now, other amendments?
16 My staff is reminding me that before we get to that point
17 we have to adopt the modification.
18 Those in favor of the modification, say aye.
19 [Chorus of Ayes]
20 The Chairman. Those opposed, say no.
21 Senator Hatch. No.
22 The Chairman. The ayes seem to have it, except for
23 Senator Hatch. The amendment is adopted.
24 Yes, Senator?
25 Senator Conrad. Mr. Chairman, could I call up the

1 substitute at this point? Would that be appropriate?

2 The Chairman. Yes. I believe any amendment is in

3 order, so we will start with you, Senator.

4 Senator Conrad. I thank the Chairman. I would call

5 up the amendment that is styled as Baucus #2.

6 The Chairman. Proceed, then.

7 Senator Conrad. I thank the Chairman.

8 Just very briefly, the fundamental difference here is

9 this amendment is paid for over 10 years, so it has the

10 same provisions on Katrina as the Chairman's mark, it has

11 all the expiring provisions for 2005, it does not include

12 expiring provisions beyond 2005.

13 On AMT, it provides better protection than the

14 Chairman's mark, protecting 600,000 more taxpayers. It

15 has the Chairman's offsets. It also includes additional

16 offsets to fully offset the cost of the bill over 10

17 years.

18 Included in those offsets are these abusive foreign

19 practices on buying our subway systems and then

20 depreciating them. It also includes a 9.7-cent-per-

21 barrel on producers and importers for the Super Fund. It

22 also deals with interest on abusive tax shelters. Those

23 are the primary additional offsets.

24 So, Mr. Chairman, I think you have done an excellent

25 job, I want to say again, in putting together this

1 package. I support virtually all the provisions, but I
2 really do believe they ought to be paid for. We can pay
3 for them, and we should pay for them when we are working
4 in the context of exploding deficit and debt.
5 The pay-go provisions that were in place in the 1990s
6 that helped us reestablish fiscal responsibility applied
7 to both spending and revenue. I have tried my very best
8 to reinstate those pay-go disciplines, and I think we
9 ought to start here. We have a chance to pay for this
10 package. It is a good package. Let us pay for it.
11 The Chairman. I want to ask Mr. Yin if you have had
12 a chance to look at this. I wanted to ask a question.
13 The author of the amendment, Senator Conrad, says over 10
14 years it is revenue neutral. But if it is not revenue
15 neutral over the five years, then it would be out of
16 order. So is it revenue neutral over the five years?
17 Mr. Yin. Over five years, Mr. Chairman, we had
18 estimated that it has a revenue loss of about $21
19 billion.
20 Senator Baucus. This is a substitute amendment.
21 This is a full substitute.
22 Mr. Yin. That is correct. The substitute
23 amendment, over the first five years, would have a
24 revenue loss of $21 billion over 10 years. It is
25 approximately revenue neutral.

1 Senator Baucus. No, this is a full substitute to
2 the mark.
3 Senator Conrad. They are correct.
4 Senator Baucus. That cannot be.
5 Senator Conrad. I think it is correct. It is less
6 costly than the Chairman's underlying mark. The
7 Chairman's underlying mark loses $60 billion. The
8 Chairman's underlying mark, over 10 years, costs $40
9 billion. Is that not correct?
10 Mr. Yin. That is correct.
11 Senator Conrad. So my amendment has a $20 billion
12 cost over 5 years, but no cost--in fact it adds a bit of
13 revenue--over 10 years. So, we are $40 billion less in
14 adding to the deficit over 5 years, and over 10 years we
15 are fully paid for, versus the Chairman's mark costing
16 $40 billion, adding to the deficit by $40 billion. Is
17 that not correct?
18 Mr. Yin. The Senator is correct.
19 Senator Conrad. So I do not know how it can be out
20 of order to have a proposal here that reduces the
21 deficit.
22 The Chairman. And I will not make that point any
23 more because I think it has been cleared up. I would
24 make these points against your amendment. Obviously, I
25 appreciate the fact that you are offering this amendment

1 in the sense that I assume it is along what you would
2 have done if you were in the Majority. However, I
3 disagree with the proposal in two important parts.
4 First, the proposal does not extend to 2009 several
5 important provisions that are important for both sides of
6 the aisle, especially Section 179 expensing which
7 encourages the growth of small business, the college
8 tuition deduction which will give parents more certainty
9 in their planning for their children's education, and the
10 low-income Saver's Credit, which assists families who
11 make less than $50,000 a year in savings for their
12 retirement.
13 Now, my second concern. I know that you stated that
14 part of your offsets are what we have in our bill, but in
15 regard to the other offsets that you have, to make it
16 revenue neutral over the 10-year period of time, I have
17 not had the opportunity to fully consider with respect to
18 the amount of money, and also, more importantly policy
19 concerns.
20 One example of what I am referring to would be the
21 revival of the environmental excise taxes, the Super Fund
22 taxes. So, I believe the mark that is before us
23 represents a more balanced bill that creates long-term
24 benefits and growth rather than limiting its focus to the
25 business of the following calendar year. So, I would ask

1 for its defeat.

2 Senator Conrad. Mr. Chairman? Mr. Chairman?

3 The Chairman. Do you want closing remarks?

4 Senator Conrad. I would like to have.

5 The Chairman. Yes.

6 Senator Crapo. I would just like to make a comment

7 before we have closing remarks.

8 The Chairman. Senator Crapo, then Senator Santorum.

9 Senator Crapo. I just want to make sure we

10 understand what the argument is here when we talk about a

11 $60 billion cost for the Chairman's mark and a zero cost

12 for the proposed substitute.

13 The reality is, if we do nothing, taxes are going to

14 go up. The Chairman's mark will stop $60 billion of tax

15 increases and that is called a cost. What that means, is

16 the Federal Government will not collect $60 billion worth

17 of taxes and those taxes will not go up.

18 When the mark that is proposed says that it is

19 revenue neutral --

20 Senator Kerry. What do you mean by, they will not

21 go up?

22 Senator Crapo. Let us take the example of the

23 college tuition deduction that is in the Chairman's mark.

24 If we do not extend the college tuition deduction then

25 the taxes that would otherwise be saved there will go up

1 by those who can no longer deduct the college tuition.
2 Senator Conrad. Would the Senator yield on that
3 point?
4 Senator Crapo. Sure.
5 Senator Conrad. That is just not right. That is
6 not what my amendment does. My amendment extends, just
7 as I said, the Saver's Credit, small business expensing
8 through this year.
9 Senator Crapo. College tuition?
10 Senator Conrad. College. All of those provisions
11 are extended that otherwise expire this year. They are
12 all extended to next year. What this amendment does, is
13 it pays for those extensions so we do not add to the
14 debt.
15 Senator Crapo. Well, wait a minute. Let me reclaim
16 my time and let me make my point. I understand what you
17 are doing. I just want to explain it.
18 Senator Conrad. Well, but you are not explaining it
19 correctly.
20 Senator Crapo. I am explaining it very correctly.
21 What you are proposing is an additional tax increase to
22 pay for not letting these other taxes go up. In the
23 other words, the Chairman is saying, let us stop a tax
24 increase.
25 You are saying, let us let the tax increase be

1 neutral by stopping some of them and raising others.
2 Hence, you propose to increase the Super Fund tax. Am I
3 wrong on that? Are you not proposing to increase the
4 Super Fund tax? Are you not proposing an entire list
5 here of additional tax increases so that you can say that
6 this is revenue neutral?
7 Senator Conrad. Mr. Chairman, might I respond?
8 The Chairman. Yes.
9 Senator Conrad. I would say what I am doing is
10 exactly what I presented. There are tax cuts here in the
11 Chairman's package that I support, and I think we all do.
12 There are a whole series of tax cuts here that will
13 otherwise expire in 2005.
14 Senator Crapo. Right.
15 Senator Conrad. I provide for the continuation of
16 those tax reductions, but I pay for them. I know this is
17 a novel idea here in Washington, that we pay for things.
18 This is exactly what we used to do when we had the pay-go
19 provisions that helped us reestablish fiscal
20 responsibility in the 1990s.
21 It said, if you want to have additional tax cuts you
22 can have them, but you have got to pay for them. If you
23 want to have additional spending, mandatory spending, you
24 can do it but you have got to pay for it. That is what I
25 am saying. I am saying, yes, there are things here that

1 are otherwise going to expire, tax reductions that would
2 otherwise lead to a tax increase.
3 But my provision will not allow those to expire. It
4 will extend that tax treatment for one year, but it will
5 pay for them. Yes, it will pay for them by raising
6 revenue elsewhere. The question is, is it appropriate?
7 Is it appropriate to close down these foreign abusive tax
8 shelters? I believe it is.
9 Is it reasonable to have a 9.7-cents-a-barrel tax on
10 oil that is going for $60 a barrel today to reestablish
11 the Hazardous Substance fund? I believe that is
12 reasonable in the context of paying for what we are doing
13 here so we do not add to the deficit and add to the debt,
14 which is already spiraling out of control.
15 Senator Crapo. Mr. Chairman, if I could conclude my
16 point.
17 The Chairman. Yes. Then I will go to Senator
18 Santorum. So, you finish your point.
19 Senator Crapo. I do not think that we are
20 disagreeing, except in the characterization of what is
21 being done. You describe it as "paying for it." There
22 are only two ways to pay for this. One, is to cut
23 spending, which you are not proposing.
24 Senator Conrad. Which we cannot do here.
25 Senator Crapo. The other, is to raise taxes, which

1 you are proposing. All I was saying is, let us be sure
2 what it is that is on the table. The Chairman's mark
3 proposes to cut taxes or to protect the existing tax cuts
4 without raising other taxes.
5 This proposal proposes to protect those tax cuts--at
6 least some of them--by raising other taxes. So the
7 question here is, are we going to do this with or without
8 an additional tax increase? I believe that the proper
9 policy answer to that is no.
10 I would just conclude by saying, at the outset,
11 several on both sides here said that this committee keeps
12 playing a shell game to keep extending tax policy one
13 year at a time. It seems to me that this shell game that
14 is described there seems to be exactly what is proposed
15 in this substitute proposal.
16 Senator Conrad. Mr. Chairman, if I might respond to
17 that by saying, read the Chairman's mark. There are
18 loads of tax increases in the Chairman's mark which the
19 Senator is about to vote for. Loads of them. You have a
20 whole list of them here, pay-fors that are in the
21 Chairman's mark. The problem with that is, he does not
22 have enough to cover what he proposes to spend.
23 Senator Crapo. The difference is about $60 billion.
24 Senator Conrad. If I could just conclude. The
25 result is, the Chairman's mark is going to borrow money

1 to pay for tax cuts. So the choice is clear: you can
2 either pay for this or borrow for it. If you want to
3 borrow more, vote for it. But to suggest one package has
4 tax cuts or tax increases and one does not is just false.
5 The Chairman's mark is loaded with tax increases.
6 Senator Crapo. The difference is $60 billion.
7 Senator Conrad. No, the difference is $40 billion.
8 Mine is revenue neutral over 10 years; the Chairman's
9 mark costs $40 billion over 10 years.
10 The Chairman. I prefer to describe my own so-called
11 tax increases. We found $180 billion over the last few
12 years in things that are examples here, of loophole
13 closings and abusive tax shelters, and that is what they
14 are, people that are avoiding taxes now that ought to pay
15 taxes without changing the rate of taxation.
16 Senator Santorum?
17 Senator Santorum. Thank you, Mr. Chairman.
18 I will agree with Senator Conrad in one of his
19 comments, that it is a novel idea to pay for spending
20 here in Washington. In fact, one of the things that we
21 have seen on the floor of the U.S. Senate over the course
22 of this year, is his colleagues on the Democratic side of
23 the aisle proposed over a half a trillion dollars, $529
24 billion, in new spending, $529 billion in amendments on
25 the floor of the U.S. Senate in new spending, offset with

1 $223 billion in tax increases. Now, that would be a $300
2 billion increase in the deficit.
3 It is a novel idea to actually come to the floor and
4 propose increases in spending and pay for them with
5 either reductions in spending or increases in taxes. It
6 is so novel that it is rarely done.
7 What we see, are complaints, again, when we try to
8 let hard-working Americans keep the money that they
9 worked hard for, that somehow or another we have to take
10 money from other hard-working Americans to pay for that
11 reduction.
12 But when it comes to spending money here in
13 Washington, then we do not have to find money somewhere
14 else in Washington, or maybe go for at least half of it
15 for other hard-working Americans to pay more money here
16 to Washington.
17 I do not hear the complaints, or the cries, or the
18 crocodile tears about deficits when it comes to
19 increasing the size and scope of government, only when it
20 comes to giving the American public the opportunity to
21 keep what they have worked hard for.
22 Senator Conrad. Mr. Chairman?
23 Senator Kerry. Mr. Chairman?
24 Senator Conrad. Mr. Chairman, I would like the
25 chance to respond, if I could. Mr. Chairman, let me just

1 be very brief. When the Senator talks about $500 billion
2 of amendments being offered on our side during the
3 budget, that is a complete concoction, and the Senator
4 knows it. That is an absolute fabrication. The Senator
5 can shake his head all he wants. That is a false
6 statement in every regard. Yes, it is, Senator.
7 Look, what you have done, is you took one-year
8 amendments and multiplied them into five-year amendments.
9 Those were not the amendments that were offered. What
10 you have done, is taken amendments that were fully offset
11 and not count the offsets. The fact is, on our side,
12 during the budget, we reduced the deficit. On your side,
13 you passed a budget that increases the deficit. That is
14 the fact.
15 Beyond that, under the circumstance that we have
16 here, it is very, very clear. You are going to borrow to
17 provide more tax cuts. You are going to borrow. You are
18 going to stick it on the charge card, you are going to
19 shove it off on our kids, you are going to run up the
20 debt.
21 When the Senator talks about spending, I would remind
22 the Senator that his side is in control of the House, of
23 the Senate, of the White House. Every dime of this
24 spending which the Senator decries has been supported by
25 your side of the aisle.

1 Every penny of this debt, which has been increased by
2 $3 trillion in the last five years, which is going to be
3 increased by another $3 trillion under the budget plan
4 before us over the next five years, is the responsibility
5 of the party opposite. This is your debt. These are
6 spending dollars which you have approved.
7 I would just say, it is time to stop. It is time to
8 stop adding to the debt, exploding the deficit, and pay
9 for things. That is what we used to do around here.
10 That is how we got out of the ditch in the 1990s,
11 together. Working together, we stopped deficit spending,
12 at least for a short time.
13 Senator Kyl. Mr. Chairman, would the Senator from
14 North Dakota yield for a question?
15 The Chairman. Could we keep it a little bit on the
16 subject before us, which is the Democrat alternative
17 amendment?
18 Senator Baucus. Mr. Chairman? Mr. Chairman?
19 The Chairman. Senator Baucus?
20 Senator Baucus. Mr. Chairman, I think there is a
21 choice here. Most of life is choices, and we have
22 choices here. The substitute in question actually closes
23 loopholes, a total of about $37 billion over five years.
24 About 13 of that is in the Chairman's modified mark, so
25 that leaves roughly about $24 billion.

1 Of the $24 billion, let us not forget that we
2 unfortunately, in this country, face a tax gap of $300-
3 some billion a year. That is taxes legally owed that are
4 just not collected. People are not paying their income
5 taxes. It is about $300-some billion a year. I do not
6 think this Congress has done enough to really address
7 that.
8 Well, in a small way this substitute amendment begins
9 to address that. So of the $24 billion remaining--
10 subtract the $13 billion which is in the mark--out of $37
11 billion, that is $24 billion--and about $14 billion of
12 that is addressing the tax gap. That is not raising
13 taxes, that is just collecting taxes, with enforcement
14 provisions, that are owed. That is not raising taxes.
15 So that leaves, oh, roughly, $10 billion.
16 What is the $10 billion? Four billion of that is in
17 the provision which says that American companies can no
18 longer disguise the offset of their foreign tax credits,
19 oil companies, by having the foreign countries
20 characterize the income as royalties as opposed to
21 income. That is a dodge, a gimmick, a charade. So, we
22 are saying that that should no longer be continued.
23 As you well know, the standard of thumb is that an
24 American company--an oil company, in this case--pays
25 taxes worldwide. If, say, Dubai or Saudi Arabia has an

1 income charged against the company, that the corporate
2 tax is offset by the U.S. company. But if it is
3 characterized as royalties that is not the case, so it
4 ends up being an extra sort of windfall to oil companies.
5 So that is just $4 billion here.
6 Then we are also saying that the Super Fund tax
7 should be reinstated. Now, that is a choice. Senators
8 may decide they do not want to reinstate the Super Fund
9 tax. We do. Why? Because there are a lot of sites left
10 in this country that are not cleaned up because companies
11 do not have the wherewithal, they cannot be found, and so
12 forth. Those sites should be addressed. But that is a
13 choice. That is a choice we make here.
14 Should we pay for this with revenue raisers which are
15 in the mark and which address the tax gap, and which
16 correct the failing in corporate tax law with respect to
17 oil company royalties overseas, and with the Super Fund
18 provision or not? I think it is important to remember
19 here, too, in this substitute, there are provisions which
20 I think we should note.
21 One, is under the substitute, fewer Americans are
22 going to be paying AMT taxes than in the mark. In the
23 mark, it only moves a slight direction. In fact, it
24 moves in the wrong direction. In the underlying mark,
25 more Americans are going to be paying the AMT than

1 currently. But under the substitute being offered here,
2 fewer Americans are going to be paying the AMT.
3 Then you add the provision with respect to the R&D
4 tax credit. The mark takes out contractors. Now,
5 frankly, I think American companies who do defense work,
6 do R&D defense work, ought to have the availability of
7 the R&D tax credit. We have that in the substitute, but
8 that is not in here.
9 This comes down to choices. Either we, in fact, do
10 tell our American public that we are going to borrow more
11 and pass this more and more off to our kids, or are we
12 going to close some loopholes and make some changes to
13 address the tax gap or not? That is a very basic
14 question.
15 It just seems to me that the more proper approach is
16 contained in this substitute, which does make AMT
17 provisions better, I think all Senators would agree, it
18 does make the R&D tax credit better, I think all Senators
19 would agree, and which pays for the extensions which we
20 all agree with, and pays for it in a way that is really,
21 really pretty painless, the fact of the matter is.
22 The rhetoric on the other side is, you are just
23 taking money away from Americans, their hard-earned
24 dollars, and so forth. I do not want to repeat myself,
25 but would just remind everyone, the provisions in this

1 bill are not in that category.

2 The provisions in this bill are in the category of
3 closing some loopholes, making some changes which do make
4 good sense, but not raising taxes on individual incomes
5 on American citizens. So, I suggest that this substitute
6 is a good measure and we should support it.

7 Senator Kyl. Mr. Chairman?

8 The Chairman. I would like to vote on the
9 substitute, if I could.

10 Senator Kyl. May I just say two things? Debating
11 these policies is important. I will just take a couple
12 of minutes. But there were two flaws in the arguments
13 proposed by our colleagues on the Democratic side.

14 The first, is we have reached a magic equilibrium in
15 our tax policy, and therefore, for any dollar in
16 reduction in taxes--in other words, dollars that the
17 American people get to keep--there has to be an increase
18 in revenues in some other way, in the form of taxes.
19 That is what pay-go is all about. Now, when did we reach
20 this magical moment when we have exactly the right amount
21 of relative taxes?

22 Well of course, if you believe in static economics, I
23 suppose one could say we have reached it. But what is to
24 say that today's exact relative taxation is right as
25 opposed to one which, next year would be a little less,

1 or the year after that a little bit more?

2 The second fatal flaw is in this focus on the cost to

3 the government. This is always very distressing to me

4 because, of course, the government does not create a

5 single -- well, it does create a few jobs. It creates

6 jobs for the people at this table, and so on. But for

7 most of Americans, the jobs are created in the private

8 sector.

9 Families earn money, they invest that money, they

10 hire people. Jobs are created by somebody else and they

11 are hired, they produce things. And by the way, taxes

12 flow into the Federal Government and to the State

13 governments as a result of that production, and the tax

14 is pertinent to that.

15 But the reality is that the cost is to the American

16 family, to the American worker, to the American business,

17 to the private sector. That is where the cost is,

18 because we take their money because we want to spend it

19 on something in the government, some things which are

20 essential, some not so essential.

21 But we have got it all backwards when we say, what is

22 the cost to the Treasury. I think we ought to say, what

23 is the cost to your family? They are the ones that are

24 working hard to earn the money and we are taking it from

25 them. What those of us on our side are saying is, we

1 ought to take less of it because they are the ones
2 producing the jobs.
3 A final point. We have got a great economy right
4 now, tremendous growth, 3.4 percent. We have had eight
5 straight quarters of over 3 percent growth. The last
6 thing you want to do is take more and more money out of
7 that private sector which is creating this economic boom
8 and creating the jobs. That is what higher taxes would
9 do. If we do not extend these current tax rates, you
10 will have a tax increase. So, I think we have got it
11 exactly wrong.
12 Yes, we do have choices. I like the choice that the
13 Republicans make, which is, let us try, if we can, to let
14 people keep more of their hard-earned money. It is
15 better for them, it is better for the economy, and as we
16 have seen with some of our tax rates, the Federal
17 Government actually turns out to earn more money on lower
18 tax rates vis-a-vis the dividends and capital gains
19 rates.
20 Senator Conrad. Mr. Chairman, I would just like to
21 sum up, then I would be prepared to vote. Mr. Chairman?
22 The Chairman. Let Senator Kerry talk first, then
23 Senator Conrad. Then we will vote.
24 Senator Conrad. Fine.
25 Senator Kerry. Mr. Chairman, thank you very much.

1 The Chairman. Please do not turn too many people on
2 over here on this side of the aisle. [Laughter].
3 Senator Kerry. Just reciprocate appropriately. I
4 will not do that, Mr. Chairman.
5 I just find, with all due respect to the Senator from
6 Pennsylvania, this argument that Democrats supported
7 whatever it was, some half a trillion dollars of
8 spending, is really just plain silly and it is insulting
9 to everybody's intelligence here.
10 The Senator knows full well that the Senators here on
11 this side of the aisle voted for a balanced budget, and
12 we balanced the budget. When government turned over, it
13 turned over a surplus of some $5.6 trillion, which is now
14 a deficit of more than that $5.6 trillion. The choice
15 could not be more clear.
16 No Senator comes to the floor offering those
17 amendments in sort of additional form. In other words,
18 if one fails, another Senator comes and tries to offer a
19 different priority, a different choice, a different
20 offset, but none of them are adding them all together
21 because they did not pass.
22 So to suggest that when you take the conglomerate of
23 all the amendments offered, that it somehow represents
24 the fiscal policy, is simply untrue and irresponsible,
25 particularly when you have a record that stands in direct

1 opposition to that, which is that we made the hard
2 choices to balance the budget and we also voted for pay-
3 go, and we also voted for a budget that would have
4 reduced the deficit, not added to it.
5 Now, to listen to the Senator talk about hard-working
6 families in America at the same time as our friends on
7 the other side of the aisle are about to pass a
8 reconciliation bill that has taxes in it that do not
9 belong in reconciliation, number one, that did not have
10 to be here, but that are adding $60 billion to the
11 deficit when ours does not, is extraordinary in itself,
12 but it is even more extraordinary when you balance it
13 against the fact that three-fifths, about 53 percent of
14 the tax cuts that you are about to vote for, would go to
15 households with more than a million dollars a year of
16 income and 0.2 percent of the households are going to
17 receive an average tax cut, therefore, of about $38,000
18 in addition to all of the other benefits they have
19 received. Now, that does not have to happen, that is
20 your choice.
21 That choice comes to the exclusion of millions of
22 families under Senator Conrad's offer, which would be
23 reduced in their exposure to the AMT. The only reason
24 that exposure goes up into the AMT is because they're
25 trying to live American values.

1 They have children and they happen to live someplace
2 that may have a high tax rate. There is no fix for that
3 in your offer, there is a fix, at least to some degree
4 that does better for those families, in what Senator
5 Conrad is offering. There would have been more if we had
6 been able to have a different alternative.
7 So, I think the choice is about as basic as it gets
8 around here. Because you have chosen to offer a
9 reconciliation that extends the tax cut for the wealthy,
10 or at least it leaves it in place until 2008, three-
11 quarters of the capital gains/dividend benefit will go to
12 people making more than $200,000 a year, and 84 percent
13 of it is going to go to those making over $200,000 a
14 year. So if we are going to stand up for the working
15 people of America, I think you would vote for Senator
16 Conrad's substitute
17 The Chairman. Well, you have got to remember,
18 Senator Kerry, we took out the dividend.
19 Senator Kerry. But we all know it is coming back in
20 on the other side. We know this is the first step. We
21 know the offsets are going to disappear. And it is still
22 in place until 2008. What you took out, was the desire
23 to increase it to 2010. That is not a big difference.
24 The Chairman. Senator Conrad?
25 Senator Conrad. Thank you, Mr. Chairman.

1 Let me just close by saying I hope my colleagues will
2 carefully consider the amendment. We extend the expiring
3 provisions that expire this year, provide for them all,
4 but we pay for it. We pay for it primarily by closing
5 loopholes, abusive tax shelters, and the rest.
6 To my colleague from Arizona, I would say with
7 respect, when he asked the question, why pay-go now, pay-
8 go is a provision that says we can have more spending if
9 we pay for it. It says we can have more tax cuts if we
10 pay for them.
11 The reason it is critical to restore fiscal
12 discipline now is because the underlying budget that has
13 been passed will increase the debt by $3 trillion over
14 the next five years.
15 Those are not my assessments of this budget package,
16 it is the sponsors' assessments of this budget package.
17 Their own numbers show they are going to increase the
18 debt $3 trillion over the next five years. Foreign
19 holdings of our debt have gone up 100 percent in four
20 years. When are we going to say, enough is enough, it is
21 time to start paying for things?
22 The Chairman. The Clerk will call the roll.
23 The Clerk. Mr. Hatch?
24 Senator Hatch. No.
25 The Clerk. Mr. Lott?

1 The Chairman. No by proxy.
2 Senator Snowe. No.
3 The Clerk. Mr. Kyl?
4 Senator Kyl. No.
5 The Clerk. Mr. Thomas?
6 Senator Thomas. No.
7 The Clerk. Mr. Santorum?
8 Senator Santorum. No.
9 The Clerk. Mr. Frist?
10 The Chairman. No by proxy.
11 The Clerk. Mr. Smith?
12 Senator Smith. No.
13 The Clerk. Mr. Bunning?
14 Senator Bunning. No.
15 The Clerk. Mr. Crapo?
16 Senator Crapo. No.
17 The Clerk. Mr. Baucus?
18 Senator Baucus. Aye.
19 The Clerk. Mr. Rockefeller?
20 Senator Rockefeller. Aye.
21 The Clerk. Mr. Conrad?
22 Senator Conrad. Aye.
23 The Clerk. Mr. Jeffords?
24 Senator Jeffords. Aye.
25 The Clerk. Mr. Bingaman?

1 Senator Bingaman. Aye.

2 The Clerk. Mr. Kerry?

3 Senator Kerry. Aye.

4 The Clerk. Mrs. Lincoln?

5 Senator Lincoln. Aye.

6 The Clerk. Mr. Wyden?

7 Senator Wyden. Aye.

8 The Clerk. Mr. Schumer?

9 Senator Schumer. Aye.

10 The Clerk. Mr. Chairman?

11 The Chairman. No.

12 The Clerk. Mr. Chairman, the tally is 9 ayes, 11
13 nays.

14 The Chairman. The amendment is defeated.

15 Senator Schumer?

16 Senator Schumer. Mr. Chairman, yes. This is number
17 7, which I would call up. It is Schumer amendment 7, and
18 would seek consent to modify my amendment and add Senator
19 Wyden as co-sponsor.

20 The Chairman. Proceed.

21 Senator Schumer. The purpose of the amendment is to
22 eliminate a tax preference enjoyed by the oil industry at
23 a time of record profits by that industry, and it is in
24 order to reduce the overall cost of the Chairman's mark.

25 Last week, I filed an amendment that would curtail or

1 disallow certain tax preferences enjoyed by big oil in
2 order to pay for a non-refundable tax credit for all
3 Americans. The first of these provisions, to disallow
4 LIFO accounting for the big oil companies in 2005, was
5 accepted by you, Mr. Chairman, and is in your modified
6 mark.
7 Senator Snowe filed an amendment with a similar
8 accounting change and this provision was included--ours
9 were very similar--and it saved $5 billion.
10 The other tax change in my amendment, which was to
11 deny the foreign tax credit with respect to royalties
12 paid by oil companies to any foreign country if the
13 country does not impose an income tax, was not included,
14 although it was in the substitute that we just defeated.
15 I would like to modify my original amendment to add
16 this second offset to the Chairman's modified mark and
17 remove the tax credit provision, it already having been
18 included.
19 I propose the amendment apply to major integrated oil
20 companies defined as those with all of the following:
21 100,000 barrels of daily domestic production; 200,000
22 barrels of average daily domestic refinery runs; and over
23 $1 billion in retail sales of refined product.
24 Adding this offset will save U.S. taxpayers $334
25 million in 2006, $4 billion over 5 years, and $10 billion

1 over 10 years. It will reduce the net cost to the
2 modified mark to $56 billion over 5 years, and $29
3 billion over 10.
4 I would urge my colleagues to support this amendment
5 so that we can take this opportunity to reduce the number
6 of tax breaks enjoyed by an industry that really does not
7 seem to need them.
8 The Chairman. So you would like to go ahead with a
9 vote on your amendment?
10 Senator Schumer. I will either go ahead, or I
11 thought our staffs had discussed it.
12 The Chairman. Yes. Well, that is what I was
13 thinking. So I was going to say to you, at least the
14 committee staff has, and through them I have, concerns
15 about the policy that you have addressed in your
16 amendment in regard to certain foreign tax credits paid
17 by dual capacity international taxpayers.
18 But as of now, I do not believe I can support it, so
19 I was hoping that we would be able to work so I could
20 become more comfortable, I should say, with the technical
21 status of your amendment.
22 I would like to have our staffs to continue working
23 together on the issue so we might be able to address this
24 issue when we move to the floor for completion of the
25 bill.

1 Senator Schumer. Mr. Chairman, that is fine with
2 me. I think, when your staff examines it, they may find
3 this acceptable. I would be happy to work with you to
4 make any changes that you think might be appropriate.
5 The Chairman. All right.
6 Senator Schumer. So I ask unanimous consent to
7 withdraw the amendment and hope we can work something
8 out.
9 The Chairman. The amendment is withdrawn.
10 Senator Lincoln, you are asking for recognition.
11 Senator Lincoln. Mr. Chairman? Yes.
12 The Chairman. Go ahead.
13 Senator Lincoln. I just simply would like to ask my
14 colleague from New York, and the Chairman, that I could
15 be included in those discussions as you all move forward
16 towards the floor, because I have quite an interest in
17 making sure those definitions we do are acceptable.
18 The Chairman. Ms. Paris has heard you.
19 Senator Lincoln. Thank you.
20 Senator Thomas. Mr. Chairman, I would like to very
21 much do the same. I am getting a little exhausted with
22 this idea that everybody wants energy coming out of the
23 sky, but they continue to think that it does not have to
24 have an investment to do it. So, I would like to be a
25 little part of your conversation as well.

1 The Chairman. All right. All right.

2 Senator Schumer. We will have one nice, big
3 conversation, Mr. Chairman.

4 The Chairman. All right.

5 Senator Wyden, did you want to proceed?

6 Senator Wyden. Yes. Thank you, Mr. Chairman, and
7 let me thank your staff. We have been working together
8 on the tax incentives portion of this legislation as it
9 relates to energy.

10 We have been talking about accounting, and I think,
11 at least with your staff, we have reached an agreement so
12 that at least this committee could begin the effort to
13 eliminate unnecessary tax incentives for oil and gas
14 companies to explore.

15 I think we saw on national TV last week why this was
16 in order. I think it just looks absurd for us to
17 constantly shovel out tax breaks when executives go on
18 the television and say they are not needed. We have got
19 to start making a distinction between the large companies
20 and the small companies.

21 So, what this amendment would do, Mr. Chairman, is it
22 would eliminate unnecessary tax incentives by limiting
23 two-year amortization of geological and geophysical
24 exploration costs by excluding the major integrated oil
25 companies. So, we are going at one of the new tax breaks

1 in the energy bill that came at a time when the
2 executives said they were not needed, came when the
3 President said they were not needed. The estimate is
4 that this tax break costs about $1 billion over 10 years.
5 The agreement that we made with your staff, Mr.
6 Chairman, is we would continue to work on this as we go
7 to the floor. Obviously we are going to have these
8 discussions as it relates to the accounting side of
9 energy policy in this committee. That is what we have
10 been debating so far, the LIFO side.
11 But this, at least, would be a start to our being
12 responsive to what we saw on national TV last week, that
13 they do not need tax incentives. We ought to start
14 confining these expenditures. In fact, I think my
15 friend, Senator Smith, would be interested in this.
16 We just had in our office the Oregon wheat growers,
17 who told us that fuel prices are so high, that they are
18 going to need fuel subsidies. They are going to ask us
19 to pass out additional money.
20 And all I could think of is, the executives told us
21 last week that they did not need the $2.7 billion that
22 Congress voted. So, I would like to see us make a start
23 with this. Mr. Chairman, I thank, again, your staff.
24 They have been very constructive. This is one step. We
25 will have to flesh out some of the terms as we go, but if

1 this is agreeable to you, I would like to go ahead.

2 The Chairman. All right. What we would do is

3 accept your amendment, with the idea that you are going

4 to be open to modification, because there may be some

5 pitfalls that we have not looked at yet. Is that all

6 right?

7 Senator Wyden. Mr. Chairman, that is very fair. I

8 want to thank you, I want to thank your staff, and I

9 think this at least is a start. I think it is

10 constructive, and I appreciate it.

11 Senator Bunning. Mr. Chairman?

12 The Chairman. Senator Bunning?

13 Senator Bunning. Mr. Chairman, there are some of us

14 that do not want to accept the amendment, but since you

15 are Chairman of this committee, we will go along with

16 you.

17 The Chairman. And be included in any upcoming

18 discussions, I assume.

19 Senator Bunning. Yes.

20 The Chairman. All right. And you are welcome.

21 Senator Thomas. Several of us want to be included

22 in that.

23 The Chairman. You are welcome.

24 Senator Thomas. To explain a little bit, what we

25 are doing to find new sources of energy is very

1 expensive. To find new sources of energy is going to
2 very important to the States where these gentlemen are
3 from because they do not have any. It would be
4 interesting to get into this.
5 The Chairman. All right. Let me see. Are there
6 any other amendments or are we ready for final passage?
7 Senator Smith. Mr. Chairman?
8 The Chairman. Senator Smith?
9 Senator Smith. Mr. Chairman, I will be brief. I
10 understand, with your staff, my amendment on mortgage
11 insurance deduction will be accepted for one year. It is
12 very important. I want my colleagues to know that this
13 is something that will probably add home ownership to
14 300,000 Americans in one year.
15 It is an amendment that affects people who are low-
16 income. It is an amendment that will make it possible
17 for more people who are disadvantaged to qualify for
18 mortgages without the after-tax expense of insurance.
19 They are required to have insurance because, frankly,
20 they have trouble coming up with the down. But if part
21 of the American dream is home ownership, the more
22 Americans we can get into a home and this will help, the
23 better that dream will be for more, and that usually
24 translates into better schools, safer neighborhoods, and
25 all kinds of things that flow from these kinds of

1 incentives. So, I believe that in the score there is
2 money for this, that is what I am told, for one year.
3 The Chairman. I think we have slimmed down your
4 amendment to some extent to do that.
5 Senator Smith. You have done that. I wish it were
6 not slimmed down, but it is a good start. I thank
7 Senator Lincoln for participating in this. It is very,
8 very important.
9 Senator Bunning. Mr. Chairman?
10 Senator Lincoln. Mr. Chairman?
11 Senator Bunning. Go ahead.
12 The Chairman. Now, do you want to speak on the
13 amendment?
14 Senator Lincoln. I just briefly want to compliment
15 my colleague, Senator Smith, and thank him for being such
16 a great and hard worker on this issue, Mr. Chairman. I
17 think we all realize that home ownership is one of the
18 smartest financial decisions that anyone can make. As we
19 look at the devastation in the Gulf Coast, and certainly
20 the fact that we have had record high home ownership in
21 this country, it is so important.
22 But without something like this, it is going to
23 become more and more difficult, as Senator Smith said,
24 for the lower to middle income individuals because we are
25 already seeing that over 10 million Americans now have

1 private mortgage insurance, and some of those families
2 would save thousands of dollars a year if their mortgage
3 insurance was tax deductible.
4 So it just creates a tremendous incentive for home
5 ownership, and I appreciate the Chairman's willingness to
6 look at it, and certainly the hard work of my colleagues.
7 Senator Wyden. Mr. Chairman?
8 The Chairman. Senator Wyden?
9 Senator Wyden. Could I just be added as a co-
10 sponsor to Senator Smith's excellent amendment?
11 The Chairman. Yes. It is my understanding you
12 already are.
13 Senator Wyden. Oh, good. [Laughter].
14 Senator Baucus. He wanted to do it again.
15 The Chairman. Let us check this out. Wyden,
16 Santorum, Bunning, Lincoln, Baucus, and Conrad. I have
17 been told that Frist is supportive. I do not know
18 whether that is true.
19 Senator Smith. That is correct, Mr. Chairman.
20 The Chairman. All right.
21 Now, if we are done with this amendment, the only
22 thing I want to say to you is, we have passed this twice.
23 I have been supportive of this. We always run into the
24 House of Representatives that just does not like it, so
25 we have a lot of work cut out. I will be a conferee, so

1 make sure that you follow through on that.

2 Senator Smith. I will do that.

3 The Chairman. If there is no objection to the

4 amendment, the amendment is accepted. [No response].

5 Who wants to be next for an amendment?

6 Senator Thomas. I would like to, sir. I was going

7 to call up my amendment number six, which has to do with

8 --

9 The Chairman. Now, wait a minute. I made a

10 mistake. I saw people pointing here and I thought it was

11 all for co-sponsorship. Senator Bunning, on the last

12 amendment?

13 Senator Bunning. You have already said enough.

14 The Chairman. All right.

15 Go ahead.

16 Senator Thomas. Thank you. I was going to call up

17 my amendment number six, which has to do with LIFO. We

18 have already talked about it. I will not take a lot of

19 time to talk about it some more at this point.

20 I do want to say, though, and emphasize, that as we

21 sit around here and we talk about deficits and we talk

22 about the economy and we talk about taxes, we ought to

23 also think a little bit about one of the strongest

24 elements that we are going to have that impact these

25 things, and that is energy.

1 You talk about a shortage of energy, then you take a
2 look at some of your expenses and some of your economy
3 and you are going to have a real problem. So it just
4 seems to me that it is a little strange that we have,
5 several times here, talked about taking away some of the
6 incentives for the production of energy in a bill in
7 which we are trying to increase the economy and reduce
8 taxes because the economy is stronger.
9 But you have already said, Mr. Chairman, that we will
10 talk about this. I take you at your word, that we will
11 have an opportunity to take a look at this LIFO
12 accounting thing. I think it is a mistake.
13 I think we have some support on both sides of the
14 aisle to take a long look at that one. So, I will not
15 ask for a vote and I will withdraw my amendment, but I
16 want to ensure that we have a chance to take a look and
17 talk about it before we go to the floor.
18 The Chairman. You will have.
19 Senator Bunning?
20 Senator Bunning. Mr. Chairman, as I said earlier, I
21 am a co-sponsor with the Senator from Wyoming on this
22 amendment. When you do consider it, I would like to be
23 included.
24 The Chairman. It is quite obvious you will be.
25 Senator Bunning. Good idea.

1 The Chairman. Senator Baucus?
2 Senator Baucus. Mr. Chairman, there are some
3 provisions in the modified mark which present some
4 procedural impediments on the floor. We have discussed
5 this, your staff and my staff have discussed this.
6 I ask consent that it be removed from the
7 modification in order to protect the procedural
8 disposition of the committee mark on the floor, and ask
9 consent that provisions B-6 and B-18 be removed from the
10 modification.
11 The Chairman. All right. Without objection, that
12 would be ordered. [No response].
13 Are you ready for final passage?
14 Senator Bunning. No.
15 The Chairman. No? Senator Santorum?
16 Senator Santorum. Mr. Chairman, as I mentioned
17 before, I appreciate the work that you have done on the
18 charitable giving package, although one of those
19 provisions was just struck, and I understood the reason
20 for that.
21 There are several provisions that were added to this
22 mark that have been categorized as charitable reforms.
23 We have worked through some of them, one just with the
24 colloquy I had with your staff on facade easements.
25 We have also worked through some concerns I have had

1 with the original mark with respect to donations of
2 clothing to make sure that there is an opportunity for
3 evaluation of clothes that may have some unique
4 characteristic, maybe owned by someone who is famous, so
5 there is a fair market valuation or a sale valuation in
6 addition to what the IRS sets as valuation for items of
7 clothing. So, I appreciate the willingness to make those
8 changes.
9 Also, some concerns I had with the charitable-owned
10 life insurance section. Again, there was concern that it
11 might extend to non-charitable organizations for the
12 secondary market, and I have been assured that we will
13 make sure that that language is clear, that it is not
14 extending to the secondary market for non-charitable
15 sales of life insurance.
16 There are two remaining areas, Mr. Chairman, in which
17 I continue to have concerns about what I see as over-
18 regulation or a little bit more zealous regulation of
19 these particular charitable organizations. I know
20 Senator Schumer has expressed similar concern with donor-
21 advised funds, and I have similar concern with supporting
22 organizations.
23 If you look at the Chairman's modification, it is 110
24 pages, with 44 provisions. These two provisions alone
25 take up 20 percent of this document. So, 20 percent of

1 this document is language on just these two provisions,
2 yet they are only 2 of 44 provisions.
3 They are voluminous and I think they are excessive
4 with respect to trying to root out the legitimate
5 concerns the Chairman has uncovered in his hearings on
6 these organizations.
7 So, I am not making the claim that there are not
8 problems with donor-advised funds or with supporting
9 organizations, Type 3 organizations in particular, but I
10 believe that the Chairman has gone farther than I think
11 is necessary and would have, I think, the undesirable
12 effect of really hampering these charitable organizations
13 in their ability to function effectively in helping the
14 charitable activities which they, in fact, do fund today.
15 Mr. Chairman, I was prepared to offer to strike those
16 provisions, and I say so because that is always in order.
17 While I have an amendment, I have some language that I
18 think would be more appropriate, I do not have a score
19 for that so it would not fit in this, and therefore it
20 would be subject to a point of order and I would be
21 concerned that I would not be successful.
22 What I would like to do, Mr. Chairman, and I know, as
23 I mentioned, Senator Schumer has concerns, Senator
24 Rockefeller, and others on the other side, as well as
25 some of my colleagues on this side, is that we try to

1 work together between now and the floor, obviously
2 reserving my right to strike these provisions when we get
3 to the floor. I hope we do not have to do that.
4 I hope we can come up with a package of reforms for
5 both DAFS and supporting organizations that can meet the
6 concerns, the legitimate concerns, that the Chairman has
7 laid out in the course of his hearings, but at the same
8 time do not, in a sense, shut down these avenues of
9 charitable organizations to support very legitimate
10 philanthropic causes and needs, very important needs,
11 DAFS in particular, with scholarships, and supporting
12 organizations with a variety of different charitable
13 activities.
14 So I will say, out of respect for the Chairman and
15 his efforts in the past to work together with me to try
16 to alleviate some of my concerns with some of the
17 charitable reforms that he has put forth, I will withhold
18 my motion to strike, but I do withhold with the clear
19 right to move forward on the floor and strike these
20 provisions if we are not able to be successful in finding
21 a compromise.
22 Thank you, Mr. Chairman.
23 Senator Kyl. Mr. Chairman?
24 Senator Rockefeller. Mr. Chairman?
25 The Chairman. Go ahead.

1 Senator Rockefeller. Just an advisement to Senator
2 Santorum. I think this bill is being taken up on the
3 floor tomorrow. Not much time.
4 The Chairman. Senator Kyl?
5 Senator Kyl. Thank you, Mr. Chairman.
6 I do take Senator Rockefeller's point, we have got to
7 work on this quickly, but I concur in what Senator
8 Santorum said and appreciate his willingness to work on
9 it. I think the two provisions that he mentioned do
10 require some further work. My only problem is, I do not
11 want to attend all these meetings. [Laughter]. But I
12 guess there is no alternative, is there, Mr. Chairman?
13 Senator Schumer. Mr. Chairman? Mr. Chairman?
14 The Chairman. Do not worry. Let me tell you with
15 certainty, Senator Santorum will look out for you very
16 well.
17 Senator Kyl. All right. Thanks, Mr. Chairman.
18 Senator Schumer. Mr. Chairman?
19 The Chairman. Senator Schumer?
20 Senator Schumer. Just one thing. Again, I agree
21 with everything that has been said by Senator Santorum
22 and others. I think we are fairly close, I think, to an
23 agreement on this. I know your staff, my staff, and
24 others have been working on this.
25 The Chairman. I have been personally involved in

1 some discussion between the hour of 1:00 and 2:00 on this
2 very subject.
3 Senator Schumer. Thank you, Mr. Chairman.
4 The Chairman. And we will continue to listen,
5 Senator Santorum, Senator Rockefeller, Senator Schumer,
6 and Senator Kyl.
7 Senator Baucus. I would name everybody on the
8 committee.
9 The Chairman. All right. All right. Everybody.
10 Also, just an editorial comment on the point about
11 the volume of pages involved with this. That is because
12 we have gone the extra mile, or extra 10 miles, to make
13 sure that we are only after those abuses that have been
14 identified.
15 The next amendment? Or are we ready for final roll
16 call?
17 Senator Lott. Mr. Chairman? If I could, just very
18 briefly.
19 The Chairman. Yes.
20 Senator Lott. First of all, on this issue, and I
21 will be brief, I think there is some well-intentioned
22 effort here, clearly. You are shooting at some big
23 targets and abuse in the system, but I think what
24 happened was, in the dragnet you caught some smaller and
25 some innocent, well-intentioned, and good provisions. It

1 looks to me like we ought to be able to find a way to get
2 ahold of the real abusers without punishing those that
3 can really be helpful.
4 I am not going to offer amendments on the 355(b)
5 provision or the R&D tax credit changes, but I want to
6 say I am very much concerned about both of them. I want
7 to continue to work with the Chairman and Senator Baucus,
8 who has been supportive of the 355(b) provisions, and
9 others that are concerned about the change in the tax
10 credit R&D provisions for manufacturers, and I think we
11 can work it out or we can find a way it could be
12 acceptable. Or, of course, we reserve the right to offer
13 an amendment, if we have to. But thank you for your
14 consideration of those two issues as we go forward, Mr.
15 Chairman.
16 The Chairman. All right. Well, on 355, my staff
17 will continue to work with your staff on the provisions
18 of your amendment and hopefully make some accommodation
19 so you do not have to offer an amendment.
20 Are we ready for a final vote? Will you call the
21 roll?
22 The Clerk. Mr. Hatch?
23 Senator Hatch. Aye.
24 The Clerk. Mr. Lott?
25 Senator Lott. Aye.

1 The Clerk. Ms. Snowe?
2 Senator Snowe. Aye.
3 The Clerk. Mr. Kyl?
4 Senator Kyl. Aye.
5 The Clerk. Mr. Thomas?
6 Senator Thomas. Aye.
7 The Clerk. Mr. Santorum?
8 Senator Santorum. Aye.
9 The Clerk. Mr. Frist?
10 The Chairman. Aye by proxy.
11 The Clerk. Mr. Smith?
12 Senator Smith. Aye.
13 The Clerk. Mr. Bunning?
14 Senator Bunning. Aye.
15 The Clerk. Mr. Crapo?
16 Senator Crapo. Aye.
17 The Clerk. Mr. Baucus?
18 Senator Baucus. Aye.
19 The Clerk. Mr. Rockefeller?
20 Senator Rockefeller. No.
21 The Clerk. Mr. Conrad?
22 Senator Conrad. No.
23 The Clerk. Mr. Jeffords?
24 Senator Jeffords. No.
25 The Clerk. Mr. Bingaman?

1 Senator Bingaman. No.

2 The Clerk. Mr. Kerry?

3 Senator Kerry. No.

4 The Clerk. Mrs. Lincoln?

5 Senator Lincoln. Aye.

6 The Clerk. Mr. Wyden?

7 Senator Wyden. No.

8 The Clerk. Mr. Schumer?

9 Senator Schumer. Aye.

10 The Clerk. Mr. Chairman?

11 The Chairman. Aye.

12 The Clerk. Mr. Chairman, the tally is 14 ayes, 6
13 nays.

14 The Chairman. Can I thank the committee, everybody,
15 for their cooperation? The bill has been adopted for
16 passage to the House.

17 I would ask unanimous consent that the staff have the
18 authority to draft necessary technical and conforming
19 changes to the Chairman's mark. Without objection, so
20 ordered. [No response]. Thank you, all.

21 [Whereupon, at 5:02 p.m. the meeting was concluded.]

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UNITED STATES SENATE
COMMITTEE ON FINANCE

Charles E. Grassley, Chairman

Thursday, November 10, 2005

215 Dirksen Senate Office Building

Agenda for Business Meeting

An Open Executive Session to consider an original bill that will include the Committee's budget reconciliation instructions pertaining to expiring tax provisions, and additional incentives for hurricane affected areas.

The following is a complete summary of S. 2020, the Tax Relief Act of 2005, as passed by the Finance Committee and pending before the full Senate.

MEMORANDUM

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

I. Hurricane Tax Relief

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

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

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

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

Additional Advance Refunding for Bonds. The proposal permits an additional advance refunding of certain governmental bonds issued by the States of Alabama, Louisiana, or

Mississippi, or any of their political subdivisions and certain 501(c)(3) bonds prior to January 1, 2007. The proposal is estimated to cost $234 million over five years.

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

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

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

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

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

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

Partial Expensing for Demolition and Cleanup Costs. Under the proposal, 50 percent of the costs (that would otherwise be capitalized) related to site cleanup and demolition

would be deductible by businesses. The proposal is estimated to cost $122 million over five years.

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

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

Hope Scholarship and Lifetime Learning Credit. Current law allows a Hope Scholarship Credit in first two years of postsecondary school equal to100% of the first $1000 of qualified tuition and related expenses, and 50% of the next $1,000 for a maximum of $1,500. There is also a Lifetime Learning Credit available to students enrolled in one or more courses at the undergraduate or graduate level (whether or not pursuing a degree), equal to 20% of the first $10,000 in qualified tuition and related expenses. The credits phase out between $42,000 and $52,000 (single filers) and $85,000 and $105,000 (married filing jointly) for 2004 (adjusted for inflation thereafter). For each year, though, taxpayers may only claim the Hope, Lifetime, or Qualified Tuition Deduction with respect to an eligible student. The provision doubles the Hope Credit dollar amounts so the maximum credit would be $3,000, and doubles the Lifetime Learning Credit percentage from 20% to 40%, for a maximum Lifetime Learning Credit of $4,000. Room and board, books and fees would also be considered qualified expenses. Cost: $55 million over five years.

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

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

- **Relax Restrictions on Mortgage Revenue Bonds.** Mortgage revenue bonds are tax-exempt bonds that State and local governments generally issue through housing

finance agencies. The proceeds from the bonds are used to fund below-market interest rate mortgages for certain first-time homebuyers meeting income and purchase price restrictions. The provision allows greater access to mortgage revenue bond proceeds by relaxing the income and purchase price limitations and lifting the first-time homeowner requirement through December 31, 2010, for homes in certain areas damaged by Hurricanes Rita and Wilma. In addition, the provision allows up to $150,000 of the loan proceeds to be used for hurricane-related repairs to damaged homes. The proposal is estimated to cost $20 million over five years.

- **Early Withdrawals from Retirement Plans.** Present law discourages distributions from tax-preferred retirement plans with penalties and other limitations. The provision waives the 10 percent penalty tax for premature distributions from IRAs and qualified retirement plans for individuals who suffered an economic loss because of Rita or Wilma and whose principal residence is located in the Rita or Wilma disaster areas. Individuals eligible for this waiver would be permitted to pay income tax on such distributions ratably over a three-year period. Amounts distributed could be re-contributed to a qualified retirement plan over the three-year period following the distribution date and receive rollover treatment. The waiver of the 10 percent penalty, 3-year income averaging and recontribution provisions for retirement plan withdrawals will be limited to $100,000 per individual. Distributions for home purchases which were not finalized because of Hurricanes Rita or Wilma could also be re-contributed to a qualified retirement plan or IRA. Limitations on loans from qualified employer plans would be increased for Hurricane Rita and Hurricane Wilma victims by doubling the thresholds to the lesser of $100,000 or 100 percent of the individual's account balance. Payments due from hurricane victims on qualified plan loans on or after August 25, 2005, and before January 1, 2007, could be deferred, and twelve months could be added to the maximum repayment period of affected loans. The proposal is estimated to cost $162 million over five years.

- **Employee Retention Credit**. Current law allows employers to deduct the cost of salaries paid to employees. This provision establishes a 40 percent tax credit for wages paid up to $6,000 if paid following Hurricanes Rita and Wilma before December 31, 2005, by employers located in the disaster zones of Hurricane Rita or Wilma without regard to the size of the employer. The employee's usual and principal place of work must have been in the disaster zone, but the credit is not affected if the employee reports to work at another location. Wages paid to relatives would be ineligible for the credit. The proposal is estimated to cost $24 million over five years.

- **Corporate Charitable Contributions.** The amount allowed as a charitable deduction for a corporation in any taxable year may not exceed 10 percent of the corporation's taxable income. The provision temporarily waives limits regarding charitable cash contributions for Rita and Wilma relief. The provision is effective for contributions before January 1, 2006. The proposal is estimated to cost $78 million over five years.

- **Casualty Loss Provision.** Under present law, non-business casualty losses are deductible by taxpayers who itemize only to the extent they exceed 10 percent of adjusted gross income and a $100 floor. In some circumstances, taxpayers are permitted to include a current-year casualty loss on an amended prior year return. The provision eliminates the 10 percent and $100 floor for casualty losses resulting from Hurricanes Rita or Wilma and incurred in the disaster area, including those claimed on amended returns. The proposal is estimated to cost $1.174 billion over five years.

II. Expiring Tax Provisions

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

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

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

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

State and Local Taxes. The JOBS Act provided that for tax years 2004 and 2005, a taxpayer may elect to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes. Taxpayers

were given two options for determining deductible sales tax: (i) actual sales tax paid if receipts are maintained for IRS verification or (ii) approximate sales tax paid as estimated in tables provided by the Secretary of the Treasury. The proposal would extend the provision through the end of 2006, and is estimated to cost $2.6 billion over five years.

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

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

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

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

Qualified Zone Academy Bonds (QZABs). QZABs are tax credit bonds issued by States or localities principally for school renovation. The bonds allow the lender to claim a tax credit against federal income taxes in lieu of receiving interest. The proposal extends the provision for one year and authorizes states to issue up to $400 million of

QZABs for 2006. Similar to recently enacted tax credit bond proposals, the proposal applies yield restriction and arbitrate rebate requirements in accordance with section 148. It imposes a requirement that the issuer reasonably expect to and actually spend the proceeds on QZAB property within five years of the date of issue. Finally, the proposal requires the use of cash or cash equivalents to meet the current-law match requirement. The provision is estimated to cost $55 million over five years.

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

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

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

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

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

Accelerated Depreciation for Business Property on Indian Reservations. A special depreciation recovery period applies to qualified Indian reservation property placed in service before January 1, 2005. In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. The proposal would extend the provision an additional year at a cost of $445 million over five years.

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

III. Provisions Affecting Charitable Tax Organizations

A. Incentives to Encourage Charitable Giving

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

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

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

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

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

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

B. Reforms Applicable to Charitable Organizations

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

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

indirectly, held an interest in the contract. The provision is subject to a de minimis rule for certain interests held as part of a diversified strategy. The bill also provides regulatory authority for the Treasury Department to except certain contracts from treatment as applicable insurance contracts. The proposal is estimated to raise $61 million over five years.

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

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

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

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

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

Appraisal Reform. The bill lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property, for which a qualified appraisal is required (i.e., appraisals are required for donations of over $5,000, under current law). The bill also provides definitions of a qualified appraiser and qualified appraisals. The proposal is estimated to raise $5 million over five years.

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

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

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

IV. MISCELLANEOUS PROVISIONS

New York Liberty Zone Incentives for Transportation Infrastructure. In 2002, a package of tax incentives were to assist in rebuilding of the New York Liberty Zone in the wake of 9-11. New York would like to restructure some of those incentives in order to obtain needed transportation infrastructure for the redevelopment of Lower Manhattan. The proposal would repeal several Liberty Zone incentives including special "bonus" depreciation, accelerated leasehold improvement recovery, increased section 179 expensing, and the extended replacement period for involuntary conversions. The proposal would provide a credit against tax imposed against New York State and City for the lesser of qualifying expenditures or the amount allocated to that governmental unit for

the calendar year. The aggregate limit that may be allocated for all calendar years is $2 billion and the estimated cost of the proposal is $239 million over five years.

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

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

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

V. OFFSETS

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

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

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

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

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

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

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

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

Increased Criminal Fines and Penalties. The provision increases criminal fines and prison sentences for the three most common offenses: failure to file, filing a false or fraudulent return, and tax evasion. These proposed changes are substantially similar to increased criminal penalty provisions passed by the Senate in the JOBS Act. One notable

change is the creation of a new aggravated failure to file offense. While retaining the current misdemeanor penalty for non-filers needed to address simple violations, the new provision creates an aggravated offense to address more serious noncompliant behavior ("aggravated" means failing to file for three or more years with an aggravated tax liability of $100,000 or more). The proposal is estimated to raise $1 million over five years.

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

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

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

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

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

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

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

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

Grant Treasury Regulatory Authority to Address Foreign Tax Credit Transactions. The provision authorizes the Secretary of the Treasury to promulgate regulations to address abusive foreign tax credit schemes that involve the inappropriate separation of foreign taxes from the related income. The provision becomes effective for transactions

entered into after the date of enactment. The proposal is estimated to raise $6 million over five years.

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

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

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

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

Impose Loan and Redemption Requirements on Pooled Financing Bonds. The proposal imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the proposal imposes a written loan requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified. Second, the issuer must reasonably expect that at least 50 percent of the net proceeds of the pooled bond will be lent to borrowers one year after the date of issue. Third, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the proposal eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of

determining whether the issuer qualified for the small issuer exception rebate. The loan commitment requirement does not apply to bonds issued by States (or an integral part of a State) to provide loans to subordinate governmental units or State entities created to provide financing for water-infrastructure projects through the EPA-sponsored State Revolving Fund Program. The proposal raises $197 million over five years.

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

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

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

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

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

JOINT COMMITTEE ON TAXATION
November 14, 2005
JCX-78-05

ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S MODIFICATION TO THE "TAX RELIEF ACT OF 2005," SCHEDULED FOR MARKUP BY THE COMMITTEE ON FINANCE ON NOVEMBER 15, 2005

Fiscal Years 2006 - 2015

[Millions of Dollars]

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
I. Hurricane Disaster Relief Provisions													
A. Tax Benefits for Areas Affected by Hurricane Katrina													
1. Tax benefits for the Gulf Opportunity Zone [1]:													
a. Special allowance for certain property acquired after 8/27/05:													
1. Equipment (sunset 12/31/07)..	ppisa 8/27/05	-791	-702	59	357	269	219	164	112	72	44	-807	-195
2. Structures (sunset 12/31/08)	ppisa 8/27/05	-545	-591	-659	-261	-17	9	31	47	58	64	-2,073	-1,863
b. Increase expensing under section 179 (sunset 12/31/07)..	ppisa 8/27/05	-31	-27	-2	17	12	9	7	5	3	2	-31	-7
c. Special allocation of private activity bond financing ($2,500 per capita)...	bia DOE & before 1/1/11	-13	-46	-87	-127	-167	-194	-200	-200	-200	-200	-440	-1,435
d. Additional advanced refunding permitted for all bonds issued by the three states and by all local issuers within Gulf Opportunity Zone (sunset 12/31/06)..	bia DOE	-37	-53	-50	-48	-46	-42	-33	-21	-14	-8	-234	-352
e. Increase in State housing credit ceiling - each of the three states receives an additional low-income housing credit allocation equal to three times the present-law allocation of credits in 2006 through 2009; Treat all Gulf Opportunity Zone property as difficult-to-develop for purposes of 130% of basis rule [2]..	aa 12/31/05	-5	-23	-54	-91	-126	-140	-140	-140	-140	-140	-299	-1,000
f. Treatment of representations regarding income eligibility for purposes of qualified residential rental project requirement...	DOE	-- *Negligible Revenue Effect* --											
g. Application of New Markets Tax Credit to investments in community development entities serving Gulf Opportunity Zone..	DOE	---	-20	-43	-50	-54	-59	-59	-59	-36	-8	-166	-387
h. Treatment of net operating losses attributable to Gulf Opportunity Zone losses..	DOE	-1,023	-326	94	169	163	138	118	100	85	72	-923	-410
i. Treatment of public utility property disaster losses...........	DOE	-128	-17	29	23	19	15	12	10	8	6	-74	-24
j. Special rule for Gulf Opportunity Zone public utility casualty losses...	DOE	-221	-40	39	33	28	24	20	17	15	13	-161	-71
k. Special rules for small timber producers:													
1. Increase reforestation expensing from $10,000 to $20,000 for expenses incurred in the Gulf Opportunity Zone, Rita Zone, and Wilma Zone (sunset 12/31/06)..	potya 8/27/05 & potya 9/23/05 & potya 10/23/05	-2	[3]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-2	---

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
2. Treat small timber growers as farmers for purposes of the 5-year NOL carryback in section 172(b)(1)(G) for losses incurred in the Gulf Opportunity Zone, Rita Zone, and Wilma Zone (sunset 12/31/06)..................................	potya 8/27/05 & potya 9/23/05 & potya 10/23/05	-1	[3]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-1	[3]
l. Partial expensing for certain demolition and clean-up costs (sunset 12/31/07)	apoia 8/27/05	-85	-39	-5	3	3	3	3	3	3	3	-122	-106
m. Extend and expand to petroleum products expensing for environmental remediation costs (sunset 12/31/07) [5]..	epoia 8/27/05	-2	-29	-18	3	3	4	3	3	3	2	-43	-27
n. Expansion of Hope Scholarship and Lifetime Learning Credits for students in the Gulf Recovery Zone..............	tyba 12/31/04 & before 1/1/07	-33	-17	---	---	---	---	---	---	---	---	-50	-50
2. Removal of employer size limitation for Hurricane Katrina employee retention credit..	wpoia 8/28/05 & before 1/1/06	-56	-18	-9	-4	-2	---	---	---	---	---	-90	-90
3. Extension of special rules for mortgage revenue bonds in the Gulf Opportunity Zone.....................................	fpb 1/1/11	---	---	-2	-7	-11	-15	-15	-15	-15	-15	-20	-96
B. Tax Benefits Related to Hurricanes Rita and Wilma [6] [7]													
1. Special rules for mortgage revenue bonds in the Hurricanes Rita and Wilma disaster areas..........................	fpb 1/1/11	-1	-3	-4	-5	-7	-7	-7	-7	-7	-7	-20	-55
2. Special Rules for Use of Retirement Funds for Relief Relating to Hurricane Rita and Wilma:													
a. Penalty-free withdrawals from retirement plans for qualified Hurricanes Rita and Wilma distributions (capped at $100,000 per taxpayer); allow amount of distribution to be repaid to an eligible retirement plan within three years and to be included in income ratably over three years.....................................	dma 9/22/05 & dma 10/22/05 & before 1/1/07	-173	-41	34	23	-5	-3	-3	-2	-2	-2	-162	-174
b. Recontributions of withdrawals for home purchases cancelled due to Hurricanes Rita and Wilma..................	dma 2/28/05 & before 9/24/05 & 10/24/05	Negligible Revenue Effect											
c. Loans from qualified plans for relief relating to Hurricanes Rita and Wilma...	[8]	Negligible Revenue Effect											
3. Employee retention credit for employers of employees affected by Hurricanes Rita and Wilma (no employer size limitation)...	wpoia 9/23/05 & wpoia 10/23/05 & before 1/1/06	-15	-5	-3	-1	[3]	---	---	---	---	---	-24	-24
4. Temporary Suspension of Limitations for Qualified Corporate Charitable Contributions (qualified corporate contributions must be for relief efforts related to Hurricanes Rita or Wilma)...................................	[9]	-85	5	1	[3]	[3]	-1	-3	-3	-3	-3	-78	-91
5. Suspend the 10% and $100 thresholds on personal casualty losses for losses which arise in the Hurricanes Rita and Wilma disaster areas................	lao/a 9/23/05 & lao/a 10/23/05	-528	-611	-35	[3]	---	---	---	---	---	---	-1,174	-1,174
Total of Hurricane Disaster Relief Provisions		**-3,775**	**-2,603**	**-715**	**36**	**63**	**-39**	**-101**	**-149**	**-170**	**-177**	**-6,994**	**-7,631**
II. Extension of Expiring Provisions													
A. Extensions Through 2009													
1. Increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset 12/31/09).................................	tyba 12/31/07	---	---	-2,605	-4,459	-209	2,707	1,772	1,222	826	476	-7,274	-271

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
2. Credit for elective deferrals and IRA contributions (sunset 12/31/09)	tyba 12/31/06	---	-481	-1,428	-1,318	-842	-15	-16	-15	-15	-15	-4,068	-4,144
3. Deduction for qualified tuition and related expenses (sunset 12/31/09)	pmi tyba 12/31/05	-420	-1,713	-1,835	-1,922	-1,504	---	---	---	---	---	-7,394	-7,394
B. Extend through 2008 and modify the New Market Tax Credit (sunset 12/31/08)	tyba 12/31/07 & DOE	---	---	-108	-168	-170	-192	-205	-202	-202	-77	-445	-1,322
C. One-Year Extensions													
1. Deduction of State and local general sales taxes (sunset 12/31/06) [10]	tyba 12/31/05	-649	-1,946	---	---	---	---	---	---	---	---	-2,594	-2,594
2. Extend the 2005 individual AMT exemption level and adjust for inflation (sunset 12/31/06)	tyba 12/31/05	-11,504	-17,255	---	---	---	---	---	---	---	---	-28,759	-28,759
3. Treatment of nonrefundable personal credits under the individual alternative minimum tax (sunset 12/31/06) [11]	tyba 12/31/05	-573	-2,291	---	---	---	---	---	---	---	---	-2,864	-2,864
4. Extend and modify the R&E credit to include alternative simplified credit and modification of "funded research" (sunset 12/31/06)	apoia 12/31/05	-3,089	-3,001	-1,389	-1,029	-695	-180	---	---	---	---	-9,204	-9,384
5. Combine work opportunity tax credit and welfare-to-work tax credit (sunset 12/31/06)	wpoifibwa 12/31/05	-211	-258	-129	-60	-33	-17	-3	[3]	---	---	-690	-710
6. Extension and modification of qualified zone academy bonds (sunset 12/31/06)	bia 12/31/05	-2	-5	-12	-17	-19	-19	-19	-19	-19	-19	-55	-150
7. Extension of enhanced deduction for qualified computer contributions (sunset for taxable years beginning after 12/31/06)	cmd tyba 12/31/05	-66	-55	---	---	---	---	---	---	---	---	-121	-121
8. Above-the-line deduction for teacher classroom expenses capped at $250 annually (sunset 12/31/06)	epoii tyba 12/31/05	-60	-139	---	---	---	---	---	---	---	---	-199	-199
9. Extend and expand to petroleum products the expensing of "Brownfields" environmental remediation costs (sunset 12/31/06)	epoia 12/31/05	-221	-136	21	24	28	25	22	20	16	14	-285	-187
10. Tax incentives for investment in the District of Columbia (sunset 12/31/06)	tyba 12/31/05	-58	-30	-2	-1	-4	-13	-46	-23	-21	-23	-95	-221
11. Indian employment tax credit (sunset 12/31/06)	wahipoia12/31/05	-21	-29	-11	-1	---	---	---	---	---	---	-62	-62
12. Accelerated depreciation for business property on Indian reservation (sunset 12/31/06)	ppisa 12/31/05	-161	-280	-104	23	77	120	98	52	6	-10	-445	-179
13. 15-year recovery of certain leasehold improvements and restaurant property (sunset 12/31/06)	ppisa 12/31/05	-69	-194	-249	-245	-239	-222	-212	-220	-216	-208	-996	-2,074
Total of Extension of Expiring Provisions		**-17,104**	**-27,813**	**-7,851**	**-9,173**	**-3,610**	**2,194**	**1,391**	**815**	**375**	**138**	**-65,550**	**-60,635**
III. Charitable Giving Incentive Provisions													
1. Provide charitable contribution deduction for nonitemizers with cash contributions in excess of $250 ($500 joint); disallow charitable contributions by itemizers which are less than or equal to $250 ($500 joint)	cmi tyba 12/31/05 & tybb 1/1/08	81	438	454	---	---	---	---	---	---	---	973	973
2. Tax-free distributions from IRAs for charitable purposes - taxpayer must have attained age 70-1/2 for contributions made directly to a charitable organization and age 59-1/2 for contributions to a split-interest entity; modify return requirements for certain trusts	tyba 12/31/05 & tybb 1/1/08	-107	-212	-121	-39	-47	-64	-78	-79	-83	-84	-526	-914

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
3. Extend present-law section 170(e)(3) deduction for food inventory to all businesses and provide special basis rule for certain taxpayers; modify the enhanced deduction for charitable contributions of donations of food inventory to equal the lesser of the item's fair market value or twice basis	cmi tyba 12/31/05 & tybb 1/1/08	-71	-180	-93	-25	---	---	---	---	---	---	-369	-369
4. Adjustment to basis of S corporation stock for certain charitable contributions	cmi tyba 12/31/05 & tybb 1/1/08	-15	-35	-22	-4	-5	-5	-5	-5	-5	-5	-81	-106
5. Modify tax treatment of certain payments to controlling exempt organizations and require disclosure and certification relating to UBIT	[12]	-59	-20	-21	-23	-25	-27	-29	-32	-35	-39	-148	-311
6. Encourage contributions of capital gain real property made for conservation purposes	cmi tyba 12/31/05 & tybb 1/1/08	-11	-36	-18	-4	---	---	---	---	---	---	-69	-69
7. Enhanced charitable deduction for contributions of book inventory with special fair market value rule	cmi tyba 12/31/05 & tybb 1/1/08	-7	-20	-10	-2	---	---	---	---	---	---	-39	-39
8. Tax involvement by exempt organization in tax shelter transactions	[13]	13	20	28	32	36	41	47	54	61	66	130	400
9. Apply an excise tax on certain acquisitions of interest in insurance contracts in which certain exempt organizations hold an interest	cia 5/3/05	3	7	12	17	22	28	34	40	47	54	61	264
10. Increase the amount of excise taxes imposed on public charities, social welfare organizations, and private foundations	tyba DOE	2	4	4	4	4	4	4	4	5	5	18	40
11. Improve accountability of donor advised funds [14]	generally tyba DOE	2	3	3	3	3	3	3	3	3	3	12	29
12. Modify rules relating to supporting organizations [15]	generally DOE	4	7	7	7	8	9	10	10	11	11	34	86
13. Limitations of charitable donations of easements on buildings located in registered historic districts	generally cma 12/16/04	2	6	6	8	9	9	9	9	10	10	31	78
14. Modifications of rules regarding donation of taxidermy and exempt use property	cma DOE & cma 6/1/06	[4]	2	5	5	5	5	5	5	5	6	18	43
15. Limit charitable contributions of clothing and household items and increased substantiation required for charitable contributions (receipts for all cash gifts; lower $250 substantiation threshold to $100)	cma 12/31/06 & cmi tyba DOE	8	38	52	48	32	32	32	32	32	33	178	339
16. Modification of rules regarding donations of fractional interests in tangible personal property	cma DOE	2	8	8	8	8	8	9	9	9	9	34	77
17. Increase penalties on taxpayers and appraiser on overstatements of value of donated property:													
a. Substantial and gross overstatements of valuations of charitable deduction property	rfa DOE	[4]	1	1	1	1	1	1	1	2	2	4	11
b. Penalty on appraisers whose appraisals result in substantial or gross valuation misstatements; definition of qualified appraisers and appraisals	aorfa DOE & rfa DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	1	3
18. Expand the base of the tax on private foundation net investment income	tyba DOE	12	17	18	19	19	20	21	21	22	23	85	192
19. Establish additional exemption standards for credit counseling organizations	[16]	1	3	4	6	7	8	9	10	11	11	21	70
Total of Charitable Giving Incentive Provisions		**-140**	**51**	**317**	**61**	**77**	**72**	**72**	**82**	**95**	**105**	**368**	**797**
IV. Miscellaneous Provisions													
1. Restructure New York Liberty Zone tax incentives	DOE	231	-61	-135	-75	-199	-243	-241	-235	-227	-223	-239	-1,408
2. Subchapter S passive investment income changes	tyba 12/31/05	-27	-89	-112	-131	-152	-167	-177	-187	-198	-209	-511	-1,449

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
3. Modification to small issue bonds - accelerate effective date for increase in capital expenditure limit	bia 12/31/06	---	-2	-9	-15	-18	-18	-18	-18	-18	-18	-44	-136
Total of Miscellaneous Provisions		**204**	**-152**	**-256**	**-221**	**-369**	**-428**	**-436**	**-440**	**-443**	**-450**	**-794**	**-2,993**
V. Revenue Offset Provisions													
A. Provisions Designed to Curtail Tax Shelters													
1. Understatement of taxpayer's liability by income tax return preparer	dpa DOE	*Negligible Revenue Effect*											
2. Modifications of suspension of interest and penalties where the IRS fails to contact taxpayer	[17]	233	92	52	19	---	---	---	---	---	---	396	396
3. Frivolous tax submissions	[18]	3	3	3	3	3	3	3	3	3	3	15	30
B. Economic Substance Doctrine													
1. Clarification of the economic substance doctrine and related penalty provisions	teia DOE	537	805	1,127	1,270	1,427	1,631	1,877	2,154	2,445	2,643	5,166	15,915
2. Penalty for understatements attributable to transactions lacking economic substance	teia DOE	*Estimate Included in Item III.B.1.*											
3. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions	teia DOE	---	1	1	3	4	4	4	4	4	4	9	29
C. Improvements in Efficiency and Safeguards in Internal Revenue Service Collection													
1. Waiver of user fee for installment agreements using automated withdrawals	aeio/a 180da DOE	-2	-3	-3	-3	-3	-4	-4	-4	-4	-5	-14	-35
2. Termination of installment agreements	foo/a DOE	*Negligible Revenue Effect*											
3. Require partial payments with submissions of offers- in-compromise (24-month rule through 11/1/10; 12-month rule thereafter)	osoaa 60da DOE	96	156	168	181	83	89	99	106	114	123	683	1,215
D. Penalties and Fines													
1. Increase in certain criminal penalties	aaftaoa DOE	[19]	[19]	[19]	[19]	[19]	[19]	[19]	[19]	[19]	[19]	1	5
2. Double certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements	oyo/a DOE	2	1	[19]	[19]	[19]	[19]	[19]	[19]	[19]	[19]	5	7
3. Denial of deduction for certain fines, penalties, and other amounts	generally apoio/a DOE	46	59	28	12	12	12	12	12	12	12	157	215
4. Deny deduction for punitive damages	dpoio/a DOE	30	31	32	33	34	35	36	37	38	39	159	343
5. Increase in penalty for bad checks and money orders	comora DOE	2	2	2	2	2	2	2	2	2	2	10	20
E. Provisions to Discourage Expatriation													
1. Tax treatment of inversion transactions	[20]	182	226	140	176	213	256	313	379	413	450	937	2,748
2. Impose mark-to-market on individuals who expatriate	[21]	66	59	57	54	50	46	43	41	39	38	286	493
F. Miscellaneous Provisions													
1. Change the tax treatment of contingent convertible debt instruments	diio/a DOE	13	34	51	61	62	57	50	46	40	36	221	450
2. Grant Treasury regulatory authority to address foreign tax credit transactions involving inappropriate separation of foreign taxes from related foreign income	teia DOE	[19]	1	1	2	2	2	2	2	2	2	6	16
3. Repeal of special effective date for qualified transportation property under the leasing provisions of the American Jobs Creation Act of 2004	[22]	8	21	26	26	26	25	23	22	22	22	108	223

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
4. Application of earnings stripping rules to partners which are C corporations	tybo/a DOE	16	23	25	27	29	31	33	35	38	41	121	299
5. Limitation of employer deduction for certain entertainment expenses	eia DOE	2	4	4	5	5	5	5	6	6	6	20	51
6. Increase in age of minor children whose unearned income is taxed as if parent's income	tyba 12/31/05	56	145	203	219	153	204	242	260	298	349	776	2,128
7. Loan and redemption requirements on pooled financings	bia DOE	25	40	42	44	46	48	50	53	56	59	197	463
8. Reporting of interest on tax-exempt bonds	ipa 1/1/06	[4]	2	2	2	2	3	3	3	3	3	9	24
9. Modify section 29/45K credit inflation adjustment and phase out rules and clarify coke production credit	qfsa 12/31/04	38	67	32	9	5	1	---	---	---	---	151	152
10. Modification of individual estimated tax safe-harbor to: 119% for tax year 2006; 110% for tax years 2007 and thereafter	tyba 12/31/05	4,513	-4,513	---	---	---	---	---	---	---	---	---	---
11. Special estimated tax rules for certain corporate estimated tax payments (3% of estimated payments otherwise due on September 15, 2010, are payable on October 1, 2010)	DOE	---	---	---	---	-1,005	1,005	---	---	---	---	-1,005	---
12. Revaluation of LIFO inventories of large integrated oil companies	tyei 2005	3,964	959	---	---	---	---	---	---	---	---	4,923	4,923
Total of Revenue Offset Provisions		9,830	-1,785	1,993	2,145	1,150	3,455	2,793	3,161	3,531	3,827	13,337	30,110
NET TOTAL		-10,986	-32,303	-6,512	-7,152	-2,690	5,254	3,719	3,469	3,389	3,444	-59,632	-40,353

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be December 1, 2005.

Legend for "Effective" column:

aa = allocations after
aaftaoa = actions and failures to act occurring after
aeio/a agreements entered into on or after
aorfa = appraisals on returns filed after
apoia = amounts paid or incurred after
apoio/a = amounts paid or incurred on or after
bia = bonds issued after
cia = contracts issued after
cma = contributions made after
cmi = contributions made in
comora = checks or money orders received after
diio/a = debt instrument issued on or after
DOE = date of enactment
dma = determinations made after

dpa = documents prepared after
dpoio/a = damages paid or incurred on or after
eia = expenses incurred after
epoia = expenditures paid or incurred after
epoii = expenses paid or incurred in
foo/a = failures occurring on or after
fpb = financing provided before
ipa = interest paid after
lao/a = losses arising on or after
osoaa = offers submitted on and after
oyo/a = open years on or after
pmi = payments made in
potya = portion of taxable year after
ppisa = property placed in service after

qfsa = qualified fuel sold after
rfa = returns filed after
teia = transactions entered into after
tyba = taxable years beginning after
tybb = taxable years beginning before
tybo/a = taxable years beginning on or after
tyei = taxable years ending in
wahipoia = wages and health insurance paid or incurred after
wpoia = wages paid or incurred after
wpoifibwa = wages paid or incurred for individuals beginning work after
60da = 60 days after
180da = 180 days after

[Footnotes for JCX-78-05 appear on the following page]

Footnotes for JCX-78-05:

[1] The "Gulf Opportunity Zone ("GO Zone")" is defined as that portion of the Hurricane Katrina disaster area determined by the President to warrant individual assistance, or individual and public assistance, from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The "Hurricane Katrina disaster area" is defined as an area with respect to which a major disaster has been declared by the President before September 14, 2005, under such Act by reason of Hurricane Katrina.
[2] Increase allocation based on population of the GO Zone. Estimate assumes one-year carryforward.
[3] Loss of less than $500,000.
[4] Gain of less than $500,000.
[5] Estimate includes interaction with item II.C.9.
[6] The term "Rita Zone" is defined as that portion of the Hurricane Rita disaster area determined by the President to warrant individual or individual and public assistance from the Federal government under such Act by reason of Hurricane Rita. The term "Hurricane Rita disaster area" is defined as an area with respect to which a major disaster has been declared by the President before October 6, 2005, under section 401 of such Act by reason of Hurricane Rita.
[7] The term "Wilma Zone" means that portion of the Hurricane Wilma disaster area determined by the President to warrant individual or individual and public assistance from the Federal government under such Act by reason of Hurricane Wilma. The term "Hurricane Wilma disaster area" is defined as an area with respect to which a major disaster has been declared by the President before October 25, 2005, under such Act by reason of Hurricane Wilma.
[8] Increase in loan limits effective for loans made after the date of enactment and before January 1, 2007; repayment relief for loans outstanding on or after September 23, 2005, and October 23, 2005.
[9] Effective for contributions made during the period beginning August 28, 2005, and ending on December 31, 2005.
[10] Includes interaction with item II.C.2.
[11] The "Economic Growth and Tax Relief Reconciliation Act of 2001" provides that the child tax credit and adoption tax credit are allowed for purposes of the alternative minimum tax for 2002 through 2010. The proposal treats the alternative motor vehicle credit and the alternative fuel vehicle refueling property credit as nonrefundable personal credits.
[12] Effective for payments received or accrued after December 31, 2000, and returns filed after the date of enactment.
[13] Generally effective for transactions that are prohibited after the date of enactment, except that no tax applies with respect to income that is properly allocable to the period ending 90 days after the date of enactment.
[14] Estimate includes interaction with the supporting organizations proposal.
[15] Estimate includes interaction with the donor advised funds proposal.
[16] Generally effective for taxable years beginning one year after the date of enactment.
[17] Effective as if included in the enactment of the American Jobs Creation Act of 2004.
[18] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).
[19] Gain of less than $1 million.
[20] Effective for certain transactions substantially completed after March 20, 2002.
[21] Generally effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after the date of enactment.
[22] Effective as if included in the provision of the American Jobs Creation Act of 2004 to which it relates.

Finance Committee
Business Meeting
11-15-05

For Insertion in the Record:

SENATOR BUNNING:

I want to bring to the chairman's attention a number of amendments that have been filed by committee members including myself.

These amendments have something in common in that they attempt to address some technical changes that are needed in order for the repatriation provision that we passed last year to work as Congress intended by allowing companies to bring additional foreign earnings back into the U.S. for reinvestment.

I understand that the Chairman was not able to accommodate these issues in this bill today. I did, however, want to raise the importance of these issues – including my Amendment #44 with Senators Lott and Santorum that attempts to insure that companies that reported us tax liability rather than unremitted earnings in their financial statements are able to take full advantage of the repatriation provisions.

I am also cosponsoring an amendment by Senator Smith that is needed to allow companies that historically have had significant amounts of so-called "Subpart F" income to be able to use the repatriation provision fully.

These matters are time sensitive due to the temporary nature of the repatriation provisions and I hope that we have an opportunity soon to address them.

SENATOR GRASSLEY:

I am aware that the repatriation provision runs out at the end of this year, and so there is a sense of urgency to making certain fixes to the provision that Congress considers appropriate.

I know of a handful of proposed fixes to the repatriation provision that are consistent with the policy objectives of the provision and make sense technically, including the proposals you mentioned, but there are a few others as well.

My staff has reviewed each of these proposals, and, in my view, they are indistinguishable from each other on technical and policy grounds. I don't see a reason to promote any single one of these fixes over another. So if one of these proposals is

done, they all ought to be done, and if all of them can't be done, then none of them should be done.

Given the limited amount of tax relief this Committee is permitted to provide in reconciliation, it is my view that there are more pressing things to spend our tax relief dollars on, like AMT relief, extension of existing tax provisions, and hurricane tax relief.

However, if there is another opportunity to revisit the repatriation provision, then we ought to consider these proposals.

Statement of Senator Jim Bunning
in support of The Tax Relief Act of 2005
15 November 2005

Mr. Chairman, I would like to express my support for the Tax Relief Act of 2005. I am glad that we are finally reviewing this bill.

I have heard a lot the last few weeks from some of my colleagues talking about how we can't afford the "tax cuts" that this bill was expected to contain. As we have been saying for weeks, the growth package is not about "tax cuts". It is about stopping tax increases – tax increases that will affect American families.

The so-called "tax cuts" that democratic members of congress are talking about are nothing more than just keeping current tax law in place.

There are over 40 provisions that American families and employers have come to rely on that will expire at the end of this year if we do nothing. These are provisions that are important to our constituents and to our economy.

Let's take a look at some of the items that are in the bill before us:

The R&D tax credit will expire at the end of this year unless we act. This is an important provision and one that almost every member of this committee supports. I thank the chairman for working with us to improve this provision in today's modification.

A lot of other important provisions will also expire if we do not act: the deduction of tuition expenses, the tax deduction for teachers' classroom expenses, and many others.

I am extremely disappointed that this bill does not contain a provision that I consider to be of vital importance – keeping the tax rate on dividend and capital gain income from increasing.

It is very important that it extend this 15% rate through the end of the budget window. As this bill moves through the legislative process I will fight to make sure that the bill that the President ultimately signs includes these vital provisions.

It is very hard to dispute the positive impact that the 15% rates have had on the macro-economy. Dividends paid by companies in the S&P 500 are up 59 percent since this tax change was implemented, and capital gains tax revenue to the federal government is set to exceed the CBO forecast by $16 billion in fiscal year 2006.

As we all know, these dividends are very important to the elderly. Many of our retired folks rely on dividends to supplement their fixed incomes from pensions and social security.

While it is true that these lower rates do not sunset until the end of 2008, it is important that we send a message to the economy by extending these rates this year.

If we have not made these provisions permanent, investors and financial markets will grow increasingly uncertain about the future tax treatment of dividends and capital gains as 2008 gets closer.

We cannot risk adding unwanted volatility into the markets and the economy – which continues to grow.

So, again, let me be clear – the proposals that we are planning to extend in this package are not *new* tax proposals – they are simply current law. If we do not extend these provisions we will cause a substantial increase in the tax bills of American families and businesses.

I also want to express my concern about two provisions that were included in the Chairman's Modification that I strongly oppose.

First, is a provision that will limit the ability of taxpayers who itemize their taxes to take a deduction for their full contributions as they do under current law. This change would amount to a tax increase on some taxpayers who make small charitable contributions and I strongly oppose it.

Second, is a provision that will change accounting rules for the oil industry. The accounting rules at issue are not some loophole for the oil industry. All taxpayers with inventories can elect to use "LIFO" inventory rules. It would be unfair to impose different rules standards on only one industry and would set a dangerous tax precedent that would introduce uncertainty into the market.

I will support this bill in Committee today.

But I am only doing so with the expectation that we will improve it and that the bill that lands on the President's desk will ultimately reflect the views of the full Senate and this Congress.

Thank you.

DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE PROVISIONS OF THE "TAX RELIEF ACT OF 2005"

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on November 15, 2005

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

November 14, 2005
JCX-77-05

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the provisions of the "Tax Relief Act of 2005," which is scheduled to be marked up by the Senate Committee on Finance on November 15, 2005.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Tax Relief Act of 2005,"* (JCX-77-05), November 14, 2005.

A. Modifications to Provisions in the Chairman's Mark[2]

1. Modification to low income housing credit (item I.A.6)[3]

Under the modification to the Chairman's mark dealing with the low income housing credit, the Gulf Opportunity Zone is treated as a high-cost area for purposes of the low income housing credit for property placed-in-service in calendar years 2006, 2007, 2008 and 2009. Therefore, buildings located in the Gulf Opportunity Zone are eligible for the enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to 91-percent and 39-percent credits, respectively. The 20-percent of population restriction is waived for this purpose. This enhanced credit applies regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap.

2. Modifications to increased expensing for reforestation expenditures of small timber producers (item I.A.12)

The modification eliminates the aggregation provisions of the Chairman's mark, which apply for purposes of determining whether a taxpayer's aggregate holdings of qualified timber property exceed 500 acres at any time during the taxable year. The modification also amends the "large timber producer" test to exclude from the increased expensing limit those taxpayers who held in excess of 500 acres as of August 28, 2005 (in the case of qualified timber property any portion of which is located in the Gulf Opportunity Zone), September 23, 2005 (in the case of qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the Gulf Opportunity Zone), or October 23, 2005 (in the case of qualified timber property any portion of which is located in the Wilma Zone). Finally, the modification excludes public corporations and Real Estate Investment Trusts ("REITs") from eligibility for the increased reforestation expensing limit.

3. Modifications to five-year NOL carryback of certain timber losses (item I.A.13)

The modification eliminates the aggregation provisions of the Chairman's mark, which apply for purposes of determining whether a taxpayer's aggregate holdings of qualified timber property exceed 500 acres as of August 28, 2005 (in the case of qualified timber property any portion of which is located in the Gulf Opportunity Zone), September 23, 2005 (in the case of qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the Gulf Opportunity Zone), or October 23, 2005 (in the case of qualified timber property any portion of which is located in the Wilma Zone). The modification also excludes public corporations and REITs from taking into account income and loss attributable to

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[2] For a description of the Chairman's mark, see Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Relief Act of 2005"* (JCX-71-05), November 8, 2005.

[3] Item numbers refer to provisions in the Chairman's mark.

qualified timber property for purposes of computing the amount of farming loss eligible for a five-year NOL carryback.

4. Modification to AMT exemption amounts (item III.B.2)

Under the Chairman's modification, the individual alternative minimum tax exemption amounts for 2006 are adjusted for inflation.

5. Deletion of provision relating to the special look-back rule for determining earned income credits and refundable child credits (item II.F)

The Chairman's modification deletes the proposal relating to the special look-back rule for determining earned income credits and refundable child credits contained in item II.F.

6. Deletion of provision relating to Secretarial authority to make certain adjustments regarding taxpayer dependency status (item II.G)

The Chairman's modification deletes the proposal relating to the Secretarial authority to make adjustments regarding taxpayer dependency status for taxpayers affected by Hurricane Rita and Hurricane Wilma contained in item II.G.

7. Deletion of extension of reduced rates on dividends and capital gains (item III.A.1)

Under the modification, the extension of reduced rates on dividends and long-term capital gains through 2009 is deleted from the Chairman's mark.

8. Modification relating to the research credit (item III.B.4)

The modified proposal eliminates the rule in the Chairman's mark requiring that research credit amounts earned in 2006 not be taken into account in computing estimated tax payments required to be paid for taxable years beginning in 2006.

The modified proposal increases the rates of the alternative incremental credit: (1) a credit rate of three percent (rather than 2.65 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent; (2) a credit rate of four percent (rather than 3.2 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent; (3) a credit rate of five percent (rather than 3.75 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

The modified proposal also creates, at the election of the taxpayer, an alternative simplified credit for qualified research expenses. The alternative simplified research is equal to 12 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 6 percent if a

taxpayer has no qualified research expenses in any one or more 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. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A special transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes the date of enactment of the modified proposal. The transition rule only applies to the taxable year which includes the date of enactment.

The modified proposal also expands the definition of "funded research" ineligible for the research credit. In general, under the modified proposal, all payments pursuant to any government contract are treated as funding research and are therefore ineligible for the research credit. Payments received pursuant to a subcontracting agreement or similar contract are also considered government funded to the extent they would be government funded under the prime contract.

Two exceptions apply with respect to government funded research. Under the first exception, government contracts having no new and significant performance specifications are not treated as funding research under the modified proposal, except where the contractor does not retain substantial rights to the research. For purposes of this exception, contracts under the modified proposal are not treated as having new and significant performance specifications where the contractor reasonably expects that not more than ten percent of the total costs of performing under the contract will be allocable to qualified research. In determining whether more than ten percent of total costs are allocable to qualified research, all research costs under a contract (including costs reasonably expected to be incurred by subcontractors and independent contractors) are considered. For purposes of this exception, options under a contract that may be exercised at the discretion of the government are treated as separate contracts. Under the second exception, qualified research undertaken by a government contractor is not to be treated as funded research unless the research is required to meet the contract's performance specifications.

The modified proposal applies to taxable years ending after December 31, 2005.

9. Deletion of provision relating to parity in the application of certain limits to mental health benefits (item III.B.5)

The modification strikes the provision in the Chairman's mark relating to parity in the application of certain limits to mental health benefits.

10. Deletion of extension of rum excise tax cover over (item III.B.8)

The modification strikes the provision in the Chairman's mark that extends the present-law limitation on the rate of rum excise tax cover over to Puerto Rico and the Virgin Islands.

11. Modifications to extension of expensing for environmental remediation costs (item III.B.11)

The modification provides that petroleum products are treated as hazardous substances for purposes of applying the brownfields expensing provision (as extended).[4] Petroleum products are defined by reference to section 4612(a)(3), and include crude oil, crude oil condensates and natural gasoline.[5] Thus, for example, the release of crude oil upon property held for use in a trade or business results in such property being treated as a qualified contaminated site. Expenditures paid or incurred to abate the contamination on or after December 31, 2005 and before December 31, 2006, would be eligible for expensing.[6]

12. Deletion of provision relating to prohibition on deferral of certain stock option and restricted stock gains (item IV.F.5)

The modification strikes the provision of the Chairman's mark relating to prohibition on deferral of certain stock option and restricted stock gains.

13. Deletion of provision related to elimination of double deduction of mining exploration and development cost under the minimum tax (item IV.F.7)

Under the modification, the provision related to elimination of double deduction of mining exploration and development cost under the minimum tax is deleted from the Chairman's mark.

14. Deletion of provision related to the holding period requirement for reduced tax rate on dividends on preferred stock (item IV.F.9)

Under the modification, the provision related to the holding period requirement for the reduced tax rate on dividends on preferred stock is deleted from the Chairman's mark.

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[4] The proposal applies to expenditures paid or incurred after December 31, 2005.

[5] The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

[6] Note that under item I.A.15 of the Chairman's mark, petroleum products are treated as hazardous substances, effective for expenditures paid or incurred after August 28, 2005, and before December 31, 2007, to abate contamination in the Gulf Opportunity Zone.

B. Additional Provisions

1. Charitable deduction for nonitemizers; floor on deductions for itemizers

Present Law

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 a charity described in section 501(c)(3),[7] to certain veterans' organizations, fraternal societies, and cemetery companies,[8] or to a Federal, State, or local governmental entity for exclusively public purposes.[9] 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.[10]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[11]

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 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 such good or service) to the taxpayer in consideration for the contribution.[12] 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

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[7] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[8] Secs. 170(c)(3)-(5).

[9] Sec. 170(c)(1).

[10] Secs. 170(b) and (e).

[11] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated for contributions made after 1986.

[12] Sec. 170(f)(8).

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 is deductible as a charitable contribution.[13]

Under present law, total deductible contributions of 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, 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 limit 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 addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2005 is $145,950 ($72,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

Description of Proposal

In the case of an individual taxpayer who does not itemize deductions, the proposal allows a deduction for nonitemizers from adjusted gross income for charitable contributions paid in cash during the taxable year. This deduction is allowed in addition to the standard deduction. The deduction is available only for that portion of contributions made during the year that in the aggregate exceed $250 ($500 in the case of a joint return). Contributions that are below the minimum amount may not be carried over for purposes of a subsequent taxable year's calculation of the deduction.

[13] Sec. 6115.

The proposal does not otherwise alter present-law rules regarding the carryover of contributions to or from a taxable year, including a taxable year in which the taxpayer elects the standard deduction. The deduction for nonitemizers generally is subject to the tax rules normally governing charitable contribution deductions, such as the substantiation requirements. The deduction is allowed in computing alternative minimum taxable income.

Under the proposal, an individual taxpayer who itemizes deductions is subject to a floor on all charitable contributions, cash and noncash, of $250 ($500 in the case of a joint return). Accordingly, the first $250 ($500 in case of a joint return) of charitable contributions of such taxpayer (whether as carryovers of excess contributions or otherwise) for each taxable year are not allowed. The proposal does not otherwise change the present-law rules pertaining to charitable contributions.

<u>**Effective Date**</u>

The proposal is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

2. Tax-free distributions from individual retirement arrangements for charitable purposes

<u>**Present Law**</u>

<u>**In general**</u>

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.

<u>**Charitable contributions**</u>

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 a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[14] or to a Federal, State, or local governmental entity for exclusively public purposes.[15] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

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[14] Secs. 170(c)(3)-(5).

[15] Sec. 170(c)(1).

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.[16]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[17]

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 such good or service) to the taxpayer in consideration for the contribution.[18] 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.[19]

Under present law, total deductible contributions of 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, 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 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.

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[16] Secs. 170(b) and (e).

[17] Sec. 170(a).

[18] Sec. 170(f)(8).

[19] Sec. 6115.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2005 is $145,950 ($72,975 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

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.[20] 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.[21] 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 to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. 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 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

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

[20] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[21] Sec. 170(f)(2).

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;[22] (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.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[23] (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[24] also are required to file Form 1041A. The returns are required to be made publicly available.[25] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[26] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Description of Proposal

Qualified charitable distributions from IRAs

The provision 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.[27]

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[22] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[23] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

[24] Sec. 642(c).

[25] Sec. 6104(b).

[26] Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

[27] The proposal does not apply to distributions from employer sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEP").

Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law 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. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to 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 provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA. It is intended that the Secretary will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

A qualified charitable distribution is defined as any distribution from an IRA that is made after December 31, 2005, and before January 1, 2008, directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity means a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2. Distributions to a split interest entity are eligible for the exclusion only if made on or after the date the IRA owner attains age 59-1/2. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, the IRA owner's spouse, or a charitable organization.

The exclusion applies to direct distributions 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. Similarly, the exclusion applies in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) otherwise would be allowable, determined without regard to the generally applicable percentage limitations.

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 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 provision) if the aggregate balance of all IRAs having the same owners were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the provision provides that subsequent distributions from the charitable remainder trust are treated as ordinary income in the hands of the beneficiary,

notwithstanding how such amounts normally are treated under section 664(b).[28] In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust has to be funded exclusively by such distributions. For example, an IRA owner may not make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the provision, a pooled income fund is eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions are treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund are not includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity is not an investment in the annuity contract.

Any amount excluded from gross income by reason of the provision is not taken into account in determining the deduction for charitable contributions under section 170.

Qualified charitable distribution examples

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution and the application of the special rules for a qualified charitable distribution to a split-interest entity. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1.–Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a direct distribution to a charitable organization. Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2.–The facts are the same as in Example 1, except that the entire IRA balance of $100,000 is distributed to a charitable remainder unitrust, which contains no other assets and which must be funded exclusively by qualified charitable distributions. Under the terms of the trust, Individual A is entitled to receive five percent of the net fair market value of the trust assets

[28] Although qualified charitable distributions by definition must be made after August 28, 2005, and before January 1, 2006, the rules of the provision (including rules relating to later distributions from an IRA or a split-interest entity) are effective with respect to and after such time period.

each year. As explained in Example 1, the entire $100,000 distribution is a qualified charitable distribution, no amount is included in Individual A's income as a result of the distribution, and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year. In addition, under a special rule in the provision for charitable remainder trusts, any distribution from the charitable remainder unitrust to Individual A is includible in gross income as ordinary income, regardless of the character of the distribution under the usual rules for the taxation of distributions from such a trust.

Example 3.–Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a direct distribution to a charitable organization, $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the provision, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions (i.e., not subject to tax upon distribution).

Split-interest trust filing requirements

The provision increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty is $100 for each day the failure continues up to a maximum of $50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[29] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from

[29] Sec. 6652(c)(4)(C).

the requirement to make information publicly available. In addition, the provision repeals the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective Date

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning after December 31, 2005, and before January 1, 2008. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2005.

3. Charitable deduction for contributions of food inventory

Present Law

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 (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). 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. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

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 (Treas. Reg. sec. 1.170A-4A(c)(3)). 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.[30]

Description of Proposal

Under the proposal, 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. 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.

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.

For purposes of calculating the enhanced deduction, taxpayers who do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A are able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[31]

The proposal changes the amount of the present-law enhanced deduction for eligible contributions of food inventory to the lesser of fair market value or twice the taxpayer's basis in the inventory. For example, a taxpayer who makes an eligible donation of food that has a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the

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[30] *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).

[31] This includes, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002-28 and 2001-10.

taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value). By contrast, under present law, a C corporation's deduction in the first example would be $7 (fair market value less half the appreciation) and in the second example would be $8. (Under present law, taxpayers other than C corporations generally could take a deduction for a contribution of food inventory only for the $4 basis in either example.) Taxpayers that do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A would be able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.

Under the proposal, the enhanced deduction 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.

In addition, the proposal provides that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market is determined without regard to such internal standards or lack of market and by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

4. Basis adjustment to stock of S corporation contributing property

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.[32] 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.[33]

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[32] Sec. 1366(a)(1)(A).

[33] Sec. 1367(a)(2)(B).

Description of Proposal

The proposal provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[34]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder will be treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by $200.

Effective Date

The proposal applies to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

5. Modify tax treatment of certain payments to controlling exempt organizations and public disclosure of information relating to UBIT

Present Law

Payments to controlling exempt organizations

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally 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. 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).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax 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).

[34] *See* Rev. Rul. 96-11 (1996-1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Public disclosure of returns

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.[35] A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is $20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is $10,000. There is no maximum penalty amount for failing to make exemption application materials available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of $5,000.[36]

These requirements do not apply to an organization's annual return for unrelated business income tax (generally Form 990-T).[37]

Description of Proposal

Payments to controlling exempt organizations

The proposal provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceed the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the larger of such

[35] Sec. 6104(d).

[36] Sec. 6685.

[37] Treas. Reg. sec. 301.6104(d)-1(b)(4)(ii).

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.

The proposal provides that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also do not apply to amounts received or accrued under such contract before January 1, 2001.

Require public availability of unrelated business income tax returns

The proposal extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to the unrelated business income tax returns of charitable organizations.[38] The proposal provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization).

Require a UBIT certification for certain large charitable organizations

A charitable organization that normally has annual total gross revenues (including contributions and grants, program service revenue, investment income, and revenues from an unrelated trade or business or other sources) or gross assets of at least $10 million must include with its Form 990 and Form 990-T filings (if any) a certification by an independent auditor or by independent counsel that the organization's filings accurately reflect the unrelated business income tax liability of the organization for the taxable year.

The certification must attest that the independent auditor or counsel with respect to the taxable year that is the subject of the return:

1. has reviewed the trades and businesses of the organization, the organization's sources of investment income, and the organization's sources of program service revenues, and, to the best of his or her knowledge, the reporting and descriptions of such items as contained in the Form 990 and, where applicable, Form 990-T, are complete and accurate;

2. reasonably believes that the organization's expense allocations between exempt, unrelated business income activities, and other activities used to determine the organization's unrelated business income tax comply with the requirements set forth in Treasury Regulations section 1.512(a)-1; and

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[38] For purposes of this proposal, a charitable organization is any organization described in section 501(c)(3) and exempt from tax under section 501(a).

3. has or has not reviewed or provided a tax opinion regarding the organization's treatment of income or an activity under the unrelated business income tax rules.[39]

Failure to satisfy the certification requirement results in a penalty, imposed on the organization, of one half of one percent (0.5 percent) of the organization's total gross revenues for the taxable year, excluding revenues from contributions and grants.

Effective Date

The proposal related to payments to controlling organizations applies to payments received or accrued after December 31, 2000. The public availability requirements of the proposal apply to returns filed after the date of enactment. The certification requirement applies to returns for taxable years that begin after the date of enactment.

6. Encourage contributions of real property made for conservation purposes

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.[40]

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, which is the 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 of 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

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[39] If the certifying party has provided or reviewed such an opinion, it also must include a description of the material facts regarding the income or activity that was the subject of such opinion.

[40] Secs. 170, 2055, and 2522, respectively.

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.

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. 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 of other charitable contributions of capital gain property.

Description of Proposal

In general

Under the proposal, 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). Thus, individuals may include the fair market value of any qualified conservation contribution of capital gain property in determining the amount of the charitable contributions subject to the 50-percent contribution base limitation.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. The 50-percent contribution base limitation applies first to contributions other than qualified conservation contributions and then to qualified conservation contributions. 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 other contributions (50 percent of the $100 contribution base) and is allowed to carryover 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 eligible farmer or rancher, a qualified conservation contribution is allowable up to 100 percent of the taxpayer's contribution base (after taking into account other charitable contributions). This rule applies both to individuals and corporations. In addition, corporate (as well as non-corporate) eligible farmers and ranchers are allowed to carryover any excess qualified conservation contributions for up to 15 years. The 100-percent contribution base limitation applies first to contributions other than qualified conservation contributions (to the extent allowable under other percentage limitations) and then to qualified conservation contributions. For example, assume an individual farmer or rancher 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 other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. The individual also is allowed a deduction of $50 in the current taxable year for the qualified charitable contribution (the amount of the remaining contribution base). The remaining $30 qualified conservation contribution may be carried forward for up to 15 years.

For this purpose, an eligible farmer or rancher means a taxpayer (other than a publicly traded C corporation) whose gross income from the trade of business of farming is at least 51 percent of the taxpayer's gross income for the taxable year.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005 and before January 1, 2008.

7. Charitable deduction for contributions of book inventory

Present Law

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 (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). 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. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

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 (Treas. Reg. sec. 1.170A-4A(c)(3)). 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.

Description of Proposal

The proposal modifies the present-law enhanced deduction for C corporations so that it is equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contributions. The proposal provides that the fair market value for this purpose is determined by reference to a bona fide published market price for the book. Under the proposal, a bona fide published market price of a book is a price of a book, determined using the same printing and same edition, published within seven years preceding the contribution, determined as a result of an arm's length transaction, and for which the book was customarily sold. For example, a publisher's listed retail price for a book would not meet the standard if the publisher could not demonstrate to the satisfaction of the Secretary that the price was one at which the book was customarily sold and was the result of an arm's length transaction. If a publisher entered into a contract with a local school district to sell newly published textbooks six years prior to making a qualified book contribution of such textbooks, the publisher could use as a bona fide published

market price, the price at which such books regularly were sold to the school district under the contract. By contrast, if a publisher listed in a catalogue or elsewhere a "suggested retail price," but books were not in fact customarily sold at such price, the publisher could not use the "suggested retail price" to determine the fair market value of the book for purposes of the enhanced deduction. Thus, in general, a bona fide published market price must be independently verifiable by reference to actual sales within the seven-year period preceding the contribution, and not to a publisher's own price list.

As an illustration of the mechanics of calculating the enhanced deduction under the proposal, a C corporation that made a qualified book contribution with a bona fide published market price of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis is $6 instead of $4, then the deduction is $10. Also, in such latter case, if the book's bona fide market published market price was $5 at the time of the contribution but was $10 five years before the contribution, then the deduction is $10.

A qualified book contribution means a charitable contribution of books to: (1) 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; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), that is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee's exempt purpose; (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 and also that the 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.

Effective Date

The proposal is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

8. Tax involvement by exempt organizations in tax-shelter transactions

Present Law

Disclosure of listed and other reportable transactions by taxpayers

Present law provides that a taxpayer that participates in a reportable transaction (including a listed transaction) and who is required to file a tax return must attach to its return a disclosure statement in the form prescribed by the Secretary.[41] For this purpose, the term

[41] Treas. Reg. sec. 1.6011-4(a).

taxpayer includes any person, including an individual, trust, estate, partnership, association, company, or corporation.[42]

Under existing regulations, a reportable transaction includes a listed transaction and five other categories of transactions: (1) confidential transactions, which are transactions offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee; (2) transactions with contractual protection, which include transactions for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, or for which fees are contingent on the taxpayer's realization of tax benefits from the transaction; (3) loss transactions, which are transactions resulting in the taxpayer claiming a loss under section 165 that exceeds certain thresholds, depending upon the type of taxpayer; (4) transactions with a significant book-tax difference; and (5) transactions involving a brief asset holding period.[43] A listed transaction means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011 (relating to the filing of returns and statements), and identified by notice, regulation, or other form of published guidance as a listed transaction.[44] The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.[45] Present law authorizes the Secretary to define reportable transaction on the basis of such transaction being of a type which the Secretary determines as having a potential for tax avoidance or evasion.[46]

Treasury regulations provide guidance regarding the determination of when a taxpayer participates in a transaction for these purposes.[47] A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction, or if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction. A taxpayer has participated in a confidential transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited under conditions of confidentiality. A taxpayer has participated in a transaction with contractual protection if the taxpayer's tax return reflects a tax benefit from the transaction, and the taxpayer has the right to the full or partial refund of fees or the fees are contingent.

Present law provides a penalty for any person who fails to include on any return or statement any required information with respect to a reportable transaction.[48] The penalty

[42] Sec. 7701(a)(1); Treas. Reg. sec. 1.6011-4(c)(1).

[43] Treas. Reg. sec. 1.6011-4(b).

[44] Sec. 6707A(c)(2); Treas. Reg. sec. 1.6011-4(b)(2).

[45] Treas. Reg. sec. 1.6011-4(a).

[46] Sec. 6707A(c)(1).

[47] Treas. Reg. sec. 1.6011-4(c)(3).

[48] Sec. 6707A.

applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any other penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner may rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

__Disclosure of listed and other reportable transactions by material advisors__

Present law requires each material advisor with respect to any reportable transaction (including any listed transaction) to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[49] The information return must include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. The return must be filed by the date specified by the Secretary.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.[50]

The Secretary may prescribe regulations which provide (1) that only one material advisor is required to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section.[51]

Present law imposes a penalty on any material advisor who fails to timely file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[52] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. An intentional failure or act by a

[49] Sec. 6707(a), as added by the American Jobs Creation Act of 2004, P.L. No. 108-357, sec. 816(a).

[50] Sec. 6707(b)(1).

[51] Sec. 6707(c).

[52] Sec. 6707(b).

material advisor with respect to the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income derived from the transaction.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner can rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

Description of Proposal

In general

In general, under the proposal, many tax-exempt entities are subject to penalties for participating in a prohibited tax shelter transaction as accommodation parties. A prohibited tax shelter transaction is a transaction that the Secretary determines is a listed transaction (as defined in section 6707A(c)(2)) or a reportable transaction that is a confidential transaction or a transaction with contractual protection (as defined by the Secretary in regulations). The proposal also clarifies that an exempt organization that participates in a reportable transaction (including a listed transaction) in order to shelter from tax the organization's own tax liability (e.g., the unrelated business income tax) is subject to the present-law rules (sec. 6707A and sec. 6011) pertaining to disclosure of such transactions.

The proposal generally applies to all tax-exempt organizations and entities organized in the United States, including charitable and other organizations described in section 501(c) (other than instrumentalities of the United States, i.e., section 501(c)(1) organizations, and foreign organizations, i.e., section 501(c)(3) organizations not organized in the United States), State and local governments, Indian tribal governments, and tax qualified pension plans, individual retirement arrangements ("IRAs"), and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Entity level tax

Under the proposal, if a tax-exempt entity participates in a transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction, the entity is subject to a tax of the greater of 100 percent of the entity's net income (after taking into account any income tax imposed with respect to the transaction) or 75 percent of the gross proceeds that is attributable to the entity's participation in the prohibited transaction.

In addition, if a transaction is not a tax shelter prohibited transaction at the time a tax-exempt entity participates in the transaction, but the transaction subsequently is determined by the Secretary to be a prohibited tax shelter transaction (a "subsequently prohibited tax shelter transaction"), the entity must pay an excise tax at the highest unrelated business taxable income rate times the greater of (i) any income that is properly allocable to the transaction after the time the transaction becomes prohibited, and (ii) 75 percent of the gross income properly allocable to the organization from the transaction after the time the transaction becomes prohibited. The Secretary has the authority to provide guidance regarding the determination of the allocation of net income of a tax-exempt entity that is attributable to a transaction to various periods, including before and after the listing of the transaction.

Neither entity level tax applies if the entity's participation is not willful and is due to reasonable cause. The entity level taxes do not apply to tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Disclosure of participation in prohibited tax shelter transactions

A person who fails to include information with respect to a prohibited tax shelter transaction on any return or statement as required by the Secretary must pay a penalty of $10,000 in the case of a natural person or $50,000 in any other case. In addition, the proposal requires that a party to a prohibited tax shelter transaction that is not a tax-exempt entity disclose to the tax-exempt entity that the transaction is a prohibited tax shelter transaction. Failure to make such disclosure is subject to the penalties described above.

The proposal requires disclosure by a tax-exempt entity to the IRS of each participation in a prohibited tax shelter transaction and disclosure of other known parties to the transaction if the tax-exempt entity knows that such transaction is a reportable transaction. The penalty for failure to disclose is imposed on the entity (or entity manager, in the case of qualified pension plans and similar tax favored retirement arrangements) at $100 per day the failure continues, not to exceed $50,000. If any person fails to comply with a demand for payment by the Secretary of such penalty, such person or persons shall pay a penalty of $100 per day (beginning on the date of the failure to comply) not to exceed $10,000 per reportable transaction.

Penalty on entity managers

A penalty of $20,000 is imposed on each entity manager that approves or otherwise causes a tax-exempt entity's participation in a prohibited tax shelter transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction. An entity manager is defined as a person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, except: (1) in the case of an entity described in section 501(c)(3) or (c)(4), an entity manager is an organization manager as defined in section 4958(f)(2), and (2) in the case of tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans), an entity manager is a person responsible for causing the entity to participate in the prohibited tax shelter transaction.

Effective Date

The proposal generally is effective for transactions after the date of enactment, except that no tax applies with respect to income that is properly allocable to the period ending on the date that is 90 days after the date of enactment. The effective date for disclosure obligations and penalties for failure to disclose is returns and statements the due date of which is after the date of enactment.

9. Apply an excise tax to acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest

Present Law

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[53] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[54]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[55]

Transfers for value

A limitation on the exclusion for amounts received under a life insurance contract is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income by reason of the death of the insured is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.[56]

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[53] Sec. 101(a).

[54] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[55] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[56] Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

Tax treatment of charitable organizations and donors

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.[57] Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.[58]

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.[59]

State-law insurable interest rules

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,[60] or, in other States, in the life of any individual who consents (whether or not the individual is a donor).[61] Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.[62]

Transactions involving charities and non-charities acquiring life insurance

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both exempt organizations, primarily charities,

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[57] Section 501(c)(3).

[58] Section 115.

[59] Section 170.

[60] See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . . ").

[61] See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40-512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

[62] Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

and private investors have an interest in the contract.[63] The exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts, sometimes together with annuity contracts. Both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

Description of Proposal

The proposal imposes an excise tax, equal to 100 percent of the acquisition costs, on the taxable acquisition of any interest in an applicable insurance contract. An applicable insurance contract is any life insurance, annuity or endowment contract in which both an applicable exempt organization and any person that is not an applicable exempt organization have, directly or indirectly, held an interest in the contract (whether or not the interests are held at the same time).

An applicable exempt organization is any organization described in section 170(c), 168(h)(2)(A)(iv), 2055(a), or 2522(a). Thus, for example, an applicable exempt organization generally includes an organization that is exempt from Federal income tax by reason of being described in section 501(c)(3) (including one organized outside the United States), a government or political subdivision of a government, and an Indian tribal government.

A taxable acquisition is the acquisition of any direct or indirect interest in an applicable insurance contract by an applicable exempt organization, or by any other person if the interest in the contract in that person's hands is not described in the specific exceptions to "applicable insurance contract."

Under the provision, acquisition costs mean the direct or indirect costs (including premiums, commissions, fees, charges, or other amounts) of acquiring or maintaining an interest in an applicable insurance contract. Except as provided in regulations, if acquisition costs of any taxable acquisition are paid or incurred in more than one calendar year, the excise tax under the provision is imposed each year with respect to costs are paid or incurred during that year. In the case of an acquisition of an interest in an entity that directly or indirectly holds an interest in an applicable insurance contract, acquisition costs are intended to include the amount of money or value of property (including an applicable insurance contract) contributed to an entity or otherwise transferred or paid to acquire or increase an interest in the entity, that directly or indirectly holds an interest in an applicable insurance contract.

For example, acquisition costs include (1) each premium, commission, or fee with respect to the contract, (2) each amount paid or incurred to acquire or increase an interest in the contract, (3) each amount paid or incurred to acquire or increase an interest in an entity (such as a partnership, trust, corporation, or other type of entity or arrangement) that has a direct or indirect

[63] Davis, Wendy, "Death-Pool Donations," Trusts and Estates, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," Wall St. J., Feb. 8, 2005, A-10.

interest in the contract, and (4) if the contract is contributed to an entity, the greater of the value of the contract or the total amount of premiums, commissions, and fees paid or incurred to acquire and maintain the insurance contract. It is intended that, under regulatory authority provided as necessary to carry out the purposes of the provision, any other similar or economically equivalent amount paid or incurred is to be treated as acquisition costs.

Under the provision, an interest in an applicable insurance contract includes any right with respect to the contract, whether as an owner, beneficiary, or otherwise. An indirect interest in a contract includes an interest in an entity that, directly or indirectly, holds an interest in the contract. In the case of a section 1035 exchange of an applicable insurance contract, any interest in any of the contracts involved in the exchange is treated as an interest in all such contracts. An increase in an interest in an applicable insurance contract is treated as a separate acquisition, for purposes of application of the excise tax under the provision.

If an interest of an applicable exempt organization exists solely because the organization holds, as part of a diversified investment strategy, a de minimis interest in an entity which directly or indirectly holds an interest in the contract, such interest is not taken into account for purposes of the proposal. For example, if an applicable exempt organization owns a de minimis amount of stock in a corporation which in turn owns life insurance contracts covering key employees, the excise tax under the provision does not apply because the stock ownership is not treated as an indirect interest in this circumstance. It is intended that Treasury regulations provide guidance as to the application of this rule so that it does not permit circumvention of the provision.

Except as provided in regulations, if a person acquires an interest in a contract before the contract is treated as an applicable insurance contract, the acquisition is treated as a taxable acquisition of an interest in applicable insurance contract as of the date the contract becomes an applicable insurance contract.

It is intended that an interest in an applicable insurance contract includes, for example, (1) a right with respect to the applicable insurance contract pursuant to a side contract or other similar arrangement, (2) an interest as a trust beneficiary in distributions from or income of a trust holding an interest in a contract, and (3) a right to distributions, guaranteed payments, or income of a partnership that holds an interest in a contract. It is not intended that a right with respect to the contract include typical rights of issuers of applicable insurance contracts.

Exceptions to the term "applicable insurance contract" apply under the proposal. First, the term does not apply if each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an insurable interest in the insured independent of any interest of the exempt organization in the contract. Second, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is as a named beneficiary. Third, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a beneficiary of a trust holding an interest in the contract, but only if the person's designation as such a beneficiary was made without consideration and solely on a purely gratuitous basis, or (2) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the benefit of applicable exempt organizations or of persons otherwise meeting one of the first two exceptions.

An exception to the term "applicable insurance contract" also is provided under the proposal in certain cases in which a person other than an applicable exempt organization has an interest solely as a lender[64] with respect to the contract, and the contract covers only one individual who is an officer, director, or employee of the applicable exempt organization with an interest in the contract, provided other requirements are met. This exception applies only if the number of insured persons under loans by such lenders with respect to such contracts does not exceed the greater of: (1) the lesser of 5 percent of the total officers, directors, and employees of the organization or 20, or (2) 5. Under this exception, the aggregate amount of indebtedness with respect to 1 or more contracts covering a single individual may not exceed $50,000.

In addition, Treasury regulatory authority is provided to except certain contracts from treatment as applicable insurance contracts. Contracts may be excepted based on specific factors including (1) whether the transaction is at arms' length, (2) whether the economic benefits to the applicable exempt organization substantially exceed the economic benefits to all other persons with an interest in the contract (determined without regard to whether, or the extent to which, such organization has paid or contributed with respect to the contract), and (3) the likelihood of abuse.

The application of the exceptions can be illustrated as follows. Assume that an individual acquires a life insurance contract in which the individual is the insured person, and the named beneficiaries are the individual's son and a university that is an organization described in section 170(c). The contract is not an applicable insurance contract because the first exception applies. That is, because both the individual and his son have an insurable interest in the individual, all persons holding any interest in the contract (other than applicable exempt organizations) have an insurable interest in the insured independent of any interest of an applicable exempt organization in the contract. The second exception also applies in this situation.

As another example, assume that the three named beneficiaries are the insured's son, an unrelated friend, and a charity. The contract is not an applicable insurance contract because the second exception applies. That is, each beneficiary's sole interest is as a named beneficiary. In addition, the first exception also applies in this situation.

As a further example, assume that the insured individual creates an irrevocable trust for the benefit of the insured's descendants, and that the trustee of the trust uses trust funds to purchase a life insurance policy on the insured's life, and the trust is both the owner and beneficiary of the insurance policy. The insured individual's naming of his or her descendants as trust beneficiaries is a gratuitous act, done without consideration. As a result, the contract is not an applicable insurance contract under the third exception.

No Federal income tax deduction is permitted for the excise tax payable under the proposal, as provided under the rule of Code section 275(a)(6). The amount of the excise tax

[64] For this purpose, an interest as a lender includes a security interest in the insurance contract to which the loan relates.

payable under the proposal is not included in the investment in the contract for purposes of section 72.

Treasury regulatory authority is provided to carry out the purposes of the provision. This includes authority to provide appropriate rules in the case in which a person acquires an interest before a contract is treated as an applicable insurance contract. This also includes authority to prevent, in cases the Treasury Secretary determines appropriate, the imposition of more than one tax if the same interest is acquired more than once (otherwise, the tax under the provision applies to each acquisition). Treasury regulatory authority is also provided to prevent avoidance of the provision, including through the use of intermediaries.

The proposal provides reporting rules requiring an applicable exempt organization or other person that makes a taxable acquisition of an applicable insurance contract to file a return containing required information and such other information as is prescribed by the Treasury Secretary. Under these rules, a statement is required to be furnished to each person whose taxpayer identification information is required to be reported on the return. Penalties apply for failure to file the return or furnish the statement, including, in the case of intentional disregard of the return filing requirement, a penalty equal to the amount of the excise tax that has not been paid with respect to the items required to be included on the return.

Effective Date

The provision is effective for contracts issued after May 3, 2005.

The application of the effective date with respect to prior acquisitions of interests may be illustrated as follows. Assume that an exempt organization and a person that is not an exempt organization described in section 170(c) form a partnership before May 3, 2005. After May 3, 2005, the partnership acquires an interest in a life insurance contract that is issued after May 3, 2005. The acquisition by the partnership of the interest in the contract is treated as a taxable acquisition under the provision by each of the partners (i.e., the exempt organization and the other person).

The provision also requires reporting of existing life insurance, endowment and annuity contracts issued on or before that date, in which an applicable exempt organization holds an interest on that date and which would be treated as an applicable insurance contract under the provision. This reporting is required within one year after the date of enactment.

10. Increase the amounts of excise taxes imposed on public charities, social welfare organizations, and private foundations

Present Law

Public charities and social welfare organizations

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private

foundations) or social welfare organizations (as described in section 501(c)(4)).[65] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[66] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[67]

Private foundations

Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[68] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (6) certain payments of money or property to a government official.[69] Certain exceptions apply.[70]

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[65] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

[66] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[67] Sec. 4958(d)(1).

[68] Sec. 4941.

[69] Sec. 4941(d)(1).

[70] See sec. 4941(d)(2).

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $10,000 per act. Such initial taxes may not be abated.[71] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[72]

Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[73] Failure to pay out the minimum results in an initial excise tax on the foundation of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[74] A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.[75] Private operating foundations are not subject to the payout requirements.

[71] Sec. 4962(b).

[72] Sec. 4961.

[73] Sec. 4942(g)(1)(A).

[74] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[75] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.[76] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[77] This five-year period may be extended an additional five years in limited circumstances.[78]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation's charitable purpose.[79] In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes. The initial tax on foundation managers may not exceed $5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed $10,000 per investment. An investment, the primary purpose of which is to accomplish a charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.[80]

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[76] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[77] Sec. 4943(c)(6).

[78] Sec. 4943(c)(7).

[79] Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[80] Sec. 4944(c).

Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.[81] In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[82] with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to $5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to $10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

Description of Proposal

Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing other than the payment of compensation by a private foundation to a disqualified person, the proposal increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. For acts of self-dealing regarding the payment of compensation by a private foundation to a disqualified person, the proposal increases the initial tax on the self-dealer from five percent of the amount involved (none of which is subject to abatement) to 25 percent of the amount involved (15 percent of which is subject to abatement). The proposal increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from $10,000 per act to $20,000 per act. Similarly, the proposal doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from $10,000 per transaction to $20,000 per transaction.

Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The proposal doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

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[81] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[82] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of $5,000 per investment is increased to $10,000 and the dollar limitation on the additional tax on foundation managers of $10,000 per investment is increased to $20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from $5,000 to $10,000, and the dollar limitation on the additional tax on foundation managers is increased from $10,000 to $20,000.

<u>**Effective Date**</u>

The proposal is effective for taxable years beginning after the date of enactment.

11. Improve accountability of donor advised funds

<u>**Present Law**</u>

<u>**Requirements for section 501(c)(3) tax-exempt status**</u>

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[83] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[84] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[85] (4) the organization may not engage in

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[83] Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

[84] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

[85] Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Classification of section 501(c)(3) organizations

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[86] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[87] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders[88]) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[89] In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[90] Certain expenditures of private foundations are also subject to tax.[91] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures

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[86] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[87] Secs. 4940 - 4945.

[88] See sec. 4946(a).

[89] Sec. 4941.

[90] Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

[91] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[92] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may also apply in the event a private foundation holds certain business interests ("excess business holdings")[93] or makes an investment that jeopardizes the foundation's exempt purposes.[94]

Charitable contributions

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.[95] Such contributions also generally are deductible for estate and gift tax purposes.[96] However, if the taxpayer retains control over the assets transferred to charity, the transfer may not qualify as a completed gift for purposes of claiming an income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[97] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[98]

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[92] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[93] Sec. 4943.

[94] Sec. 4944.

[95] Sec. 170.

[96] Secs. 2055 and 2522.

[97] A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[98] Sec. 170(b).

In general, taxpayers who make contributions and claim a charitable deduction must satisfy recordkeeping and substantiation requirements.[99] The requirements vary depending on the type and value of property contributed. A deduction generally may be denied if the donor fails to satisfy applicable recordkeeping or substantiation requirements.

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[100] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.[101] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

Community foundations

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographic area. Donors sometimes make contributions to a community foundation through transfers to a separate trust or fund, the assets of which are held and managed by a bank or investment company.

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[99] Sec. 170(f)(8).

[100] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

[101] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

Certain community foundations are subject to special rules that permit them to treat the separate funds or trusts maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that community foundations must meet is that funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several non-adverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material. In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

<u>**Donor advised funds**</u>

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

Under the Katrina Emergency Tax Relief Act of 2005, certain of the above-described percent limitations on contributions to public charities are temporarily suspended for purposes of

certain "qualified contributions" to public charities. Under the Act, qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor.

Description of Proposal

Definitions

Donor advised fund

The proposal defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors[102] (2) owned and controlled by a sponsoring organization and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor") or by a donor advisor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. Notwithstanding the foregoing, the term "donor advised fund" does not include a fund or account from which are made grants to individuals for travel, study, or other similar purposes by such individual, provided that (1) a donor's or donor advisor's advisory privileges are performed exclusively by such donor or donor advisor in their capacity as a member of a committee appointed by the sponsoring organization, (2) no combination of a donor and persons related to or appointed by such donor, control, directly or indirectly, such committee, and (3) all grants from such fund or account satisfy requirements similar to those described in section 4945(g) (concerning grants to individuals by private foundations).

Sponsoring organization

The proposal defines a "sponsoring organization" as an organization that: (1) is described in section 170(c) (other than section 170(c)(1), and without regard to section 170(c)(2)(A)); and (2) maintains one or more donor advised funds.

Donor

Under the proposal, a "donor" is an individual, corporation, partnership, trust, estate, or other person that makes a contribution to a sponsoring organization, which contribution is maintained or intended to be maintained in a donor advised fund.

Investment advisor

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[102] The requirement that a donor advised fund be separately identified by reference to contributions of a donor or donors is intended to exclude from the definition of "donor advised fund" certain types of funds or accounts maintained by community foundations and other charities, such as field-of-interest funds and scholarship funds, provided such funds or accounts are not separately identified by reference to contributions of a donor or donors.

Under the proposal, the term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

Deductibility of contributions to a sponsoring organization for maintenance in a donor advised fund

Contributions to certain sponsoring organizations for maintenance in a donor advised fund not eligible for a charitable deduction

Under the proposal, contributions to a sponsoring organization for maintenance in a donor advised fund will not be eligible for a charitable deduction for income tax purposes if the sponsoring organization is an organization described in sections 170(c)(3), 170(c)(4), 170(c)(5), or 509(a)(3); for gift tax purposes if the sponsoring organization is an organization described in sections 2522(a)(3) or 2522(a)(4); or for estate tax purposes if the sponsoring organization is an organization described in sections2055(a)(3) or 2055(a)(4).

Additional substantiation requirements

In addition to satisfying present-law substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

Minimum distributions

Aggregate payout requirement

Under the proposal, a sponsoring organization is required, before the end of a taxable year of the organization, to make qualifying distributions, from the assets of donor advised funds maintained by the organization, equivalent to five percent of the aggregate asset value of donor advised funds maintained by the sponsoring organization in the immediately preceding taxable year. The proposal excludes from the computation of the required distributable amount for a taxable year the assets of donor advised funds that have been in existence for less than one full year as of the end of the immediately preceding taxable year.[103] The aggregate payout rule does

[103] Assume, for example, that a sponsoring organization ("S") initially maintained 10 donor advised funds, each established in Year 1. In Year 3, a new donor advised fund is established. For purposes of determining S's aggregate payout requirement for Year 4, the donor advised fund established in Year 3 is excluded, because it was in existence for less than a year as of the end of Year 3. For these purposes, a donor advised fund is deemed created when the account is first established (rather than when a donor achieves the minimum account balance required under the sponsoring organization's rules to begin grantmaking, if later).

not apply in the case of a donor advised fund maintained by a private foundation that is subject to the requirements of section 4942.

Account-level activity requirement

General rule

Under the proposal, each donor advised fund maintained by a sponsoring organization must distribute at least a certain amount in qualifying distributions during any applicable three-year period. If such amount is not distributed from a donor advised fund during such period, the proposal requires that the sponsoring organization distribute such amount from such account as qualifying distributions within 120 days. The required distributable amount is the greater of (1) $250 or (2) two and one-half percent of the sponsoring organization's average required minimum initial contribution amount for such period[104] (or average required minimum balance, if greater) for the type of donor[105] at issue. An applicable three-year period must correspond with three consecutive taxable years of the sponsoring organization. The first applicable three-year period for a donor advised fund begins only after the fund has been in existence for one full year.[106]

Account-level distribution requirement for accounts that hold illiquid assets

If, as of the end of any taxable year of the sponsoring organization, a donor advised fund holds assets other than cash and marketable securities (i.e., "illiquid assets") that equal more than 10 percent of the total value of assets in the account (determined using the following valuation procedures), the donor advised fund must distribute as qualifying distributions within 12 months of the close of such taxable year at least five percent of the value of the assets in the donor advised fund as of the end of such year (the "illiquid asset payout requirement"). If such amount is not distributed from a donor advised fund by such time, the proposal requires that the sponsoring organization distribute such amount from such fund as qualifying distributions within 120 days.

If a donor advised fund holds illiquid assets representing 10 percent of the fund's value as of the end of a taxable year of the sponsoring organization, but did not hold such assets for a

[104] For purposes of the proposal, the required minimum initial contribution amount is the minimum contribution amount required by the sponsoring organization in order to open a donor advised fund.

[105] Under some circumstances, for example, a sponsoring organization may establish higher minimum initial contribution amounts for corporate donors than for individual donors.

[106] Applicable three-year periods for any donor advised fund run consecutively, such that the second three-year period begins immediately after the first three-year period ends. For example, assume donor advised fund X is established on March 30 of Year 1, and the sponsoring organization's taxable year corresponds to the calendar year. As of the end of Year 1, X has not been in existence for one full year; therefore, X's first applicable three-year period does not begin in Year 2. Instead, the first such period begins on January 1 of Year 3 and runs through December 31 of Year 5. X's second applicable three-year period begins on January 1 of Year 6 and ends on December 31 of Year 8.

period of 12 months, the fund is treated as holding only cash and marketable securities for purposes of the illiquid asset payout requirement for such year. If, however, the donor advised fund holds illiquid assets at the beginning of a taxable year of a sponsoring organization and such assets are during such year exchanged for illiquid assets that are held at the end of such year, the donor advised fund is deemed to have held illiquid assets for the entire taxable year of the sponsoring organization, and the account is subject to the illiquid asset payout requirement. The Secretary is authorized to promulgate anti-abuse rules to prevent the circumvention of the proposal through transactions designed to avoid application of illiquid asset payout requirement, such as through exchanges of illiquid assets for other assets.

Qualifying distributions

For purposes of all of the distribution requirements described in the proposal, qualifying distributions are amounts paid to organizations described in section 170(b)(1)(A) (other than supporting organizations described in section 509(a)(3) or a sponsoring organization if the amount is for maintenance in a donor advised fund). Distributions to the sponsoring organization are qualifying distributions if the distribution is designated for use in connection with a charitable program of the sponsoring organization (e.g., if funds are transferred to a scholarship fund (that does not meet the definition of donor advised fund because, for example, the scholarship fund is not separately identified by reference to donors) for the awarding of scholarships consistent with the sponsoring organization's exempt purposes).[107] Amounts permanently set aside for purposes, and under procedures similar to those, described in section 4942(g) will be treated as qualifying distributions.

Valuation

Special valuation rules apply for purposes of determining the required distributable amount for a taxable year under the aggregate payout requirement and the account-level payout requirement applicable to accounts that hold illiquid assets. For such purposes, the fair market values of cash and of securities for which market quotations are readily available are determined on a monthly basis. All other assets ("illiquid assets") transferred by a donor to a sponsoring organization for maintenance in a donor advised fund are valued at the sum of (1) the value claimed by the donor for purposes of determining the donor's charitable deduction for the contribution of such assets to the sponsoring organization,[108] and (2) an assumed annual rate of return of five percent. If a donor advised fund invests in illiquid assets, such assets are valued at the sum of (1) the purchase price paid for the assets, and (2) an assumed annual rate of return of five percent. The Secretary of the Treasury is authorized to specify the requirements for making such computations. Under the proposal, the Secretary of the Treasury is also authorized to

[107] Neither the payment of administrative expenses, nor distributions to the sponsoring organization for administrative expenses, qualifies for purposes of the aggregate payout requirement.

[108] The donor is required to report to the sponsoring organization the value of the asset claimed by the donor for charitable deduction purposes either by supplying to the sponsoring organization a copy of the donor's completed Form 8283 related to the deduction (if applicable) or by following any alternative procedures specified by the Secretary in regulations.

promulgate rules permitting adjustments in the value of an illiquid asset in situations where the asset declines significantly in value following a contribution or purchase of the asset.

Treatment of qualifying distributions

Distributions made in satisfaction of any of the above-described distribution requirements are counted for purposes of all payout requirements described in the proposal. For purposes of any distribution requirement described in this proposal, the taxpayer may designate a qualifying distribution as being made out of the undistributed amount remaining from any prior taxable year or as being made in satisfaction of the distribution requirement for the current taxable year. Amounts distributed in excess of the undistributed amount for the current year and all previous taxable years may be carried forward for up to five taxable years following the taxable year in which the excess payment is made.

Penalties for failure to distribute

In the event of a failure to distribute the required amount in connection with any of the above-described distribution requirements within the prescribed time period, the proposal imposes excise taxes similar to the private foundation excise taxes under section 4942. Specifically, a first-tier excise tax equal to 30 percent[109] of the undistributed amount is imposed. The first-tier tax may be abated if the failure was due to reasonable cause and not to willful neglect. If the failure is not corrected within the taxable period (as defined in existing section 4942(j)(1)), a second-tier tax equal to 100 percent of the undistributed amount is imposed.

Prohibited transactions and sanctions

The proposal provides that donors, donor advisors, and investment advisors to donor advised funds (as well as persons related to the foregoing persons[110]) automatically are treated as disqualified persons with respect to the sponsoring organization under section 4958 or under section 4946(a).

The proposal also provides that distributions from a donor advised fund to a person that with respect to such fund is a donor, donor adviser, or a person related to a donor or donor adviser (though not an investment advisor) automatically will be treated as an excess benefit transaction under section 4958, with the entire amount paid to the disqualified person being deemed the amount of the excess benefit. (The section 4958 tax on organization managers also would apply.) This rule applies regardless of whether the sponsoring organization is a public

[109] Under a separate proposal, the first-tier tax under section 4942 would be increased from 15 percent to 30 percent.

[110] For purposes of the proposal, a person is treated as related to another person if (1) such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

charity or a private foundation and regardless of whether, but for this rule, the transaction would have been subject to the section 4941 self-dealing rules.[111]

Any amount repaid as a result of correcting such an excess benefit transaction shall not be held in or credited to any donor advised fund with respect to which the donor or donor advisor has or reasonably expects to have advisory privileges. The Secretary is authorized to issue regulations specifying how such payments may be made.

Under the proposal, distributions from a donor advised fund (as opposed to a sponsoring organization's non donor advised funds or accounts) to any person other than the sponsoring organization's non donor advised funds or accounts or organizations described in section 170(b)(1)(A)[112] (other than supporting organizations described in clause (viii) or sponsoring organizations for maintenance in a donor advised fund) are prohibited.[113] The proposal provides for a penalty in the event a distribution is made from a donor advised fund to an ineligible person, such as a private non-operating foundation or a supporting organization. In the event of such a distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against any donor or donor advisor who advised that such distribution be made. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) who knowingly approved the distribution. The taxes described in this paragraph are subject to abatement.

Under the proposal, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund receives, directly or indirectly, a benefit as a result of a distribution from such donor advised fund, and such benefit is more than incidental, excise taxes are imposed against any donor or donor advisor who recommended the distribution, and against the recipient of the benefit. The amount of the tax is determined by multiplying the rate of the initial tax imposed against a disqualified person under section 4958 by the amount of the distribution that gave rise to the more-than-incidental benefit. Persons subject to the tax are jointly and severally liable for the entire amount of the tax. In addition, if a manager of the

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[111] This rule includes any distribution to a donor, donor advisor, or a related person, whether in the form of a grant, loan, compensation arrangement, expense reimbursement, or other payment. If the excess benefit results from the payment of compensation, the entire amount paid as compensation will be deemed the amount of the excess benefit, whether the sponsoring organization is a private foundation or a public charity.

[112] By requiring that distributions from a donor advised fund be made only to certain entities, the proposal prohibits distributions from a donor advised fund to a donor or donor advisor (or person related to a donor or donor advisor), whether as compensation, loans, or reimbursement of expenses.

[113] Under the proposal, distributions from donor advised funds to individuals are prohibited. However, sponsoring organizations may make grants to individuals from amounts not held in donor advised funds and may establish scholarship funds that are not donor advised funds. A donor may choose to make a contribution directly to such a scholarship fund (or advise that a donor advised fund make a distribution to such a scholarship fund).

sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) who participated in the approval of the distribution knew at the time of such participation that the distribution would confer a more-than-incidental benefit on a donor, a donor-advisor, or a person related to a donor or donor advisor of a donor advised fund, the manager also is subject to an excise tax, calculated by multiplying the rate of the initial tax specified under section 4958 with respect to organization managers by the amount of the distribution that gave rise to the more-than-incidental benefit. The taxes described in this paragraph are subject to abatement if it is established that the taxable event was due to reasonable cause and not to willful neglect.

Reporting and disclosure

The proposal requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization's taxable year; and (3) the aggregate contributions to and grants made from those funds during the year. The statute of limitations for assessing any tax arising under the proposal in any year with respect to which the required information has not been provided shall not expire before three years after the date on which the required information is disclosed to the IRS.

In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds and must provide detailed information regarding its planned operation of such funds, including, for example, a description of procedures it intends to use to: (1) communicate to donors and donor advisors that assets held in donor advised funds are the property of the sponsoring organization; and (2) ensure that distributions from donor advised funds do not result in more than incidental private benefit to any person.

Effective Date

The proposal is generally applicable on the date of enactment. Payout requirements are effective for taxable years beginning after the date of enactment. Information return requirements are effective for taxable years ending after the date of enactment. The requirements concerning disclosures on an organization's application for tax exemption are effective for organizations applying for recognition of exempt status after the date of enactment. Requirements relating to charitable contributions to donor advised funds are effective contributions made after 180 days from the date of enactment.

12. Improve accountability of supporting organizations

Present Law

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A

charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[114] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[115] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[116] (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.[117] Under present law, the information return requirement does not apply to several categories of exempt organizations. Organizations exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[118]

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[114] Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

[115] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

[116] Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

[117] Sec. 6033(a)(1).

[118] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

Classification of section 501(c)(3) organizations

In general

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[119] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[120] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders[121]) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[122] In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[123] Certain expenditures of private foundations are also subject to tax.[124] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt

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[119] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[120] Secs. 4940 - 4945.

[121] See sec. 4946(a).

[122] Sec. 4941.

[123] Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

[124] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

operating foundation unless the foundation exercises expenditure responsibility[125] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may apply in the event a private foundation holds certain business interests ("excess business holdings")[126] or makes an investment that jeopardizes the foundation's exempt purposes.[127]

Public charities also enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[128] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[129]

Supporting organizations (section 509(a)(3))

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[130] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[131] (the "organizational and

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[125] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[126] Sec. 4943.

[127] Sec. 4944.

[128] A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[129] Sec. 170(b).

[130] Sec. 509(a)(3).

[131] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

operational tests");[132] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[133] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[134]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[135]

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[136] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[137]

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported

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[132] Sec. 509(a)(3)(A).

[133] Sec. 509(a)(3)(B).

[134] Sec. 509(a)(3)(C).

[135] Treas. Reg. sec. 1.509(a)-4(f)(2).

[136] Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

[137] Id.

organizations.[138] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[139]

Type III supporting organizations

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a "responsiveness test" and an "integral part test."[140]

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. The responsiveness test may be satisfied in one of two ways.[141] First, the supporting organization may demonstrate that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.[142] Alternatively, the responsiveness test may be satisfied if the supporting organization is a charitable trust under state law, each specified supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.[143]

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[138] Treas. Reg. sec. 1.509(a)- 4(h)(1).

[139] Treas. Reg. sec. 1.509(a)-4(h)(2).

[140] Treas. Reg. sec. 1.509(a)-4(i)(1).

[141] For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)-4(i)(1)(ii).

[142] Treas. Reg. sec. 1.509(a)-4(i)(2)(ii).

[143] Treas. Reg. sec. 1.509(a)-4(i)(2)(iii).

In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.[144] The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;[145] (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement");[146] and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the "attentiveness requirement."[147]

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[148] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the

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[144] Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

[145] For this purpose, the IRS has defined the term "substantially all" of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

[146] Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

[147] Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

[148] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

five-year period ending on the date of the transaction at issue.[149] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

Description of Proposal

Proposals relating to all (Type I, Type II, and Type III) supporting organizations

Prohibited transactions

Supporting organizations (Type I, Type II, or Type III) are prohibited from making grants, loans, compensation, or other similar payments to a substantial contributor (or person related to the substantial contributor)[150] of the supporting organization. If a prohibited payment is made, the substantial contributor is treated as a disqualified person and the transaction is treated as an excess benefit transaction with the entire amount of the payment treated as the excess benefit. The prohibition does not apply if the substantial contributor is a public charity (other than a supporting organization). A substantial contributor is similar to a person as described in section 507(d)(2).

Loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are prohibited. With respect to any such loan, the loan is treated as an excess benefit transaction and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization).

Disclosure requirements

All supporting organizations are required to file an annual information return (Form 990 series) with the Secretary, regardless of the organization's gross receipts. A supporting organization must indicate on such annual information return (and on the application for tax-

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[149] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

[150] For purposes of this proposal, a person is treated as related to another person if such person bears a relationship to such other person similar to the relationships described in section 4958(f)(1)(B) or section 4958(f)(1)(C).

exempt status) whether it is a Type I, Type II, or Type III supporting organization. A supported organization must identify on its Form 990 filed with the Secretary the organizations with respect to which it is a supported organization.

Supporting organizations must demonstrate annually that the organization is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations) through a certification on the annual information return that the majority of the organization's governing body is comprised of individuals who were selected based on their special knowledge or expertise in the particular field or discipline in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities, and who have no family, personal, or business relationship to any of the organization's disqualified persons.

Excess business holdings

The excess business holdings rules of section 4943 are applied to supporting organizations. In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors as described in section 507(d)(2) and persons related to substantial contributors and persons similar to those described in section 4943(a)(1)(H). The Secretary has the authority not to impose the excess business holding rules if the organization establishes to the satisfaction of the Secretary that the excess holdings are consistent with the exempt purposes of the organization.

Proposals that apply only to Type III supporting organizations

Modify payout requirement of Type III supporting organizations

A Type III supporting organization must pay each taxable year, to or for the use of one or more public charities described in section 509(a)(1) or 509(a)(2), the sum of (1) the greater of (i) 85 percent of its income or (ii) five percent of the aggregate fair market value of all of the assets of the organization other than assets that are used (or held for use) directly in supporting the charitable programs of the supporting organization or one or more supported organizations, determined as of the last day of the taxable year, and (2) any amount received or accrued in such year as repayments of amounts that were taken into account as support provided by the supporting organization in prior years. In general, the distributable amount for a taxable year must be distributed before the first day of the second taxable year following such year, under rules similar to the distribution rules under section 4942. For purposes of any distribution requirement described in this proposal, the taxpayer may designate a qualifying distribution as being made out of the undistributed amount remaining from any prior taxable year or as being made in satisfaction of the distribution requirement for the current taxable year. Amounts distributed in excess of the undistributed amount for the current year and all previous taxable years may be carried forward for up to five taxable years following the taxable year in which the excess payment is made.[151]

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[151] Under present law, certain Type III organizations are required to pay out substantially all of their income to section 509(a)(1) or 509(a)(2) organizations. Such Type III organizations also must

A supporting organization's administrative and operating expenses do not count as expenses to or for the use of a supported organization. The holding of assets for investment purposes, or to operate a trade or business, is not considered a use or holding for use directly to support a supported organization's charitable programs. The Secretary may provide guidance as to types of uses of assets that are considered to be directly in support of a supported organization's charitable programs similar to guidance provided under Treasury Regulation section 53.4942(a)-2(c)(3)(i).

An organization that fails to meet the payout requirement is subject to an initial tax of 30 percent of the unpaid amount, increased to 100 percent of the unpaid amount if the payout requirement is not met by the earlier of the date of mailing of a notice of deficiency with respect to the initial tax or the date on which the initial tax is assessed.

Organizational and operational requirements

A Type III supporting organization may not support more than five organizations, may not support an organization that is not organized in the United States,[152] and may not be a donor with respect to a donor advised fund. However, a Type III supporting organization may provide support to a sponsoring organization of a donor advised fund to the extent the support is not for maintenance in a donor advised fund.

Relationship to supported organization(s)

A Type III supporting organization must, as part of its exemption application (Form 1023) attach a letter from each organization that is designated by the supporting organization as receiving its support.

On the annual information return filed by a Type III supporting organization, the organization must indicate that it has obtained letters from organizations that received its support. All such letters must be signed by a senior officer or a member of the Board of the supported organization and must show (1) that the supported organization agrees to be supported by the supporting organization, (2) the type of support provided or to be provided, and (3) how such support furthers the supported organization's charitable purposes.

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establish that a substantial amount of the total support provided must go to organizations that meet the present law "attentiveness" requirement. The proposal does not change this requirement but does extend it to Type III supporting organizations that under present law are not subject to a payout requirement (by virtue of satisfying Treasury Regulation section 1.509(a)-4(i)(3)(ii)).

[152] U.S. charities established principally to provide financial and other assistance to a foreign charity, sometimes referred to as "friends of" organizations, may not be established as supporting organizations under the proposal. Such organizations may continue to obtain public charity status, however, by virtue of demonstrating broad public support (as described in sections 509(a)(1) and 509(a)(2)).

A Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure the supporting organization's responsiveness. Such a showing could be satisfied, for example, through provision of documentation such as a copy of the supporting organization's governing documents, any changes made to the governing documents, the organization's annual information return filed with the Secretary (Form 990 series), any tax return (Form 990-T) filed with the Secretary, and an annual report (including a description of all of the support provided by the supporting organization, how such support was calculated, and a projection of the next year's support). Failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.

A type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization.

Other provisions

If a Type I or Type III supporting organization supports an organization that is controlled, directly or indirectly, by a donor (other than a public charity that is not a supporting organization) of the supporting organization or person related to the donor (or any combination of such persons), then the supporting organization is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as a supporting organization.

For purposes of the excess benefit transaction rules, a disqualified person of a supporting organization is treated as a disqualified person of the supported organization.

A non-operating private foundation may not count as a qualifying distribution under section 4942 any amount paid to a supporting organization. In addition, any amount paid to a supporting organization shall be treated as a taxable expenditure under section 4945 unless the private foundation exercises expenditure responsibility with respect to the grant.

Effective Date

The proposal generally is effective on the date of enactment. The limitation on supporting no more than five organizations is effective for organizations established on or after the date of enactment (but organizations established before the date of enactment may not increase the number of organizations supported above the number of organizations supported on the date of enactment, and may not add new supported organizations as beneficiaries unless no more than five organizations are supported by the supporting organization following such addition). The distribution requirements are effective for taxable years beginning after the date of enactment. The prohibited transaction rules are effective for transactions occurring after the date of enactment. The excess business holdings requirements generally are effective for taxable years beginning after the date of enactment, but transition rules similar to the rules under sections 4943(c)(4) and 4943(c)(5) shall apply. The limitations on charitable contributions of capital gain property are effective for taxable years beginning after the date of enactment. The return

requirements are effective for returns filed for taxable years ending after the date of enactment. Making a showing to a supported organization in satisfaction of the responsiveness test is effective for taxable years beginning after the date of enactment.

13. Reform rules for charitable contributions of easements on buildings in registered historic districts

Present Law

In general

Present law provides special rules that apply to charitable deductions of qualified conservation contributions, which include conservation easements and façade easements.[153] Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.[154] Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value charitable deduction.

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.[155] 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.[156]

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[153] Sec. 170(h).

[154] Sec. 170(f)(3).

[155] Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)).

[156] Sec. 170(h)(4)(A).

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[157] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[158]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.[159] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[160] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[161]

Valuation

The value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[162]

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.[163] In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[164] If such benefits are greater

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[157] Treas. Reg. sec. 1.170A-14(e)(2).

[158] Treas. Reg. sec. 1.170A-14(e)(2).

[159] Sec. 170(f)(11)(C).

[160] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[161] Treas. Reg. sec. 1.170A-13(c)(3).

[162] Treas. Reg. sec. 1.170A-14(h)(3).

[163] Treas. Reg. sec. 1.170A-14(h)(3)(i).

[164] *Id.*

than those that will inure to the general public from the transfer, no deduction is allowed.[165] In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[166]

Preservation of a certified historic structure

A certified historic structure means any building, structure, or land which is (i) listed in the National Register, or (ii) located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.[167] For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify.[168] If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[169]

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.[170] In general, a facade easement is a restriction the purpose of which is to preserve certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the structure if the owner obtains consent from the qualified organization that holds the easement.

Description of Proposal

The proposal revises the rules for qualified conservation contributions with respect to property located in a registered historic district. Under the proposal, a charitable deduction is not allowable with respect to a structure or land area located in such a district. A charitable deduction is allowable with respect to buildings (as is the case under present law) but the qualified real property interest that relates to the exterior of the building must preserve the entire

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[165] *Id.*

[166] Treas. Reg. sec. 1.170A-14(h)(3)(ii).

[167] Sec. 170(h)(4)(B).

[168] Treas. Reg. sec. 1.170A-14(d)(5)(iii).

[169] Treas. Reg. sec. 1.170A-14(d)(5)(i).

[170] *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

exterior of the building, including the space above the building, the sides, the rear, and the front of the building, and the building must be habitable. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed or altered in a manner inconsistent with the historical character of such exterior. Taxpayers must obtain a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest) and attach the appraisal with the taxpayer's return. Appraisals must include photographs of the entire exterior of the building and descriptions of all current restrictions on development of the building, including zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information in the appraisal results in disallowance of the deduction.

Qualified conservation contributions with respect to a building located in a registered historic district are not allowed unless the donee organization has been accredited by the National Trust for Historic Preservation.[171] In developing an accreditation program, the National Trust for Historic Preservation shall consult with the Internal Revenue Service, the National Park Service, and State Historic Preservation Officers as described in 16. U.S.C. sec 470a(b). Such accreditation program is required to develop best practices for donee organizations, such as establishing standards for regular monitoring of interests held by an organization, maintenance of sufficient resources to monitor and enforce interests held by an organization, and conflicts of interest policies to be followed in connection with the solicitation and administration of contributions. Accreditation must be obtained at least once every five years, and an organization must show that its current resources are sufficient to monitor and enforce existing interests held by the organization, that it has effectively monitored and enforced such interests, that the organization either has sufficient resources to monitor new interests or can demonstrate that such resources will be available for monitoring and enforcing new interests, that the organization follows a suitable conflict of interest policy with respect to solicitation and administration of contributions, that the organization does not engage in deceptive or misleading promotional practices, and that the organization has a policy to ensure that restrictions held by the organization will be protected in perpetuity in the event the organization can no longer sufficiently monitor and enforce the restriction. Accreditation standards and the procedure for accreditation must be complete by January 1, 2007. In addition, under the proposal, a governmental unit (as described in section 170(b)(1)(A)(v)) is no longer an eligible donee for such contributions.

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district are subject to a limitation on the amount allowed as a deduction for the qualified conservation contribution equal to the greater of three percent of the fair market value of the underlying property or $10,000. As an alternative to being subject to such limitation, a taxpayer may pay a $500 fee to the Internal Revenue Service. Amounts paid are required to be dedicated to Internal Revenue Service enforcement of qualified conservation contributions.

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[171] The National Trust for Historic Preservation is an organization chartered by Congress pursuant to 16. U.S.C. secs. 468-468d.

Effective Date

The proposal generally is effective for contributions made after the date of enactment, except that the requirement that a qualified real property interest be with respect to the entire exterior of the building is effective for contributions made after December 16, 2004. The limitation on the amount that may be deducted and the filing fee is effective for contributions made 180 days after the date of enactment. The requirement that a donee organization be accredited is effective on January 1, 2008.

14. Reform rules relating to charitable contributions of taxidermy and recapture tax benefit on property not used for an exempt use

Present Law

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[172] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[173] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[174] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. 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

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[172] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[173] Secs. 170(b) and (e).

[174] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[175] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of taxidermy are subject to the tangible personal property rule (number (2) above). For example, for appreciated taxidermy, if the property is used to further the donee's exempt purpose, the deduction is fair market value. But if the property is not used to further the donee's exempt purpose, the deduction is the donor's basis. If the taxidermy is depreciated, i.e., the value is less than the taxpayer's basis in such property, taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Substantiation

No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization.[176] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution (and a good faith estimate of the value of any such goods or services).

In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[177] C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed is more than $5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the

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[175] 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. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

[176] Sec. 170(f)(8).

[177] Sec. 170(f)(11).

donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000 or more, and to attach an appraisal summary to the tax return.[178] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[179] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[180] In the case of contributions of art valued at more than $20,000 and other contributions of more than $500,000, taxpayers are required to attach the appraisal to the tax return. Taxpayers may request a Statement of Value from the Internal Revenue Service in order to substantiate the value of art with an appraised value of $50,000 or more for income, estate, or gift tax purposes.[181] The fee for such a Statement is $2,500 for one, two, or three items or art plus $250 for each additional item.

If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value of $5,000 or more (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282) with the Secretary, and to furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.[182]

Description of Proposal

Donation of taxidermy for an exempt use

For contributions of exempt-use taxidermy property with a claimed value of more than $500 but not more than $5,000, the individual must include on the Form 8283 a photograph of the taxidermy and comparable sales data for similar items within the previous six months. Valuation must be based on comparable sales. The Secretary shall not allow a deduction if sufficient comparable sales are not provided.

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[178] *Id.*

[179] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[180] Treas. Reg. sec. 1.170A-13(c)(3). Sec. 170(f)(11)(E).

[181] Rev. Proc. 96-15, 1996-1 C.B. 627.

[182] Sec. 6050L(a)(1).

For claims of more than $5,000, the taxpayer must request a Statement of Value from the IRS by the time the taxpayer files the return claiming the deduction. The Statement of Value is similar to that available under present law for items of art. The IRS shall assess an average fee of $500 for the Statement of Value.

Determination of basis in taxidermy

For purposes of the charitable contribution deduction, a taxpayer may not include in the taxpayer's basis of the contributed taxidermy any costs attributable to travel.

Recapture of tax benefit upon subsequent disposition of tangible personal property intended for an exempt use

In general, the proposal recovers the tax benefit for charitable contributions of tangible personal property that are not used for exempt purposes. The proposal applies to appreciated tangible personal property that is identified by the donee organization as for a use related to the donee's basis for tax exemption, and for which a deduction of more than $5,000 is claimed ("applicable property").[183] If the donee organization disposes of applicable property within three years of the receipt of the property, the donor is subject to recapture of the tax benefit. If the disposition occurs in the contribution tax year, the donor's deduction generally is basis and not fair market value.[184] If the disposition occurs in a subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

There is no recapture of the tax benefit if the donee organization makes a certification to the Secretary, by written statement signed under penalties of perjury by an officer of the organization (other than the donor or a person related to the donor). The certification must explain either (1) the use of the property and how such use substantially furthered the purpose or function that constitutes the organization's basis for exemption, or (2) that the intended related use of the property became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (as part of the present-law requirement to furnish the Form 8282 to the donor).

Reporting of exempt use property contributions

In addition to the present-law requirement that the donee organization identify on the Form 8283 whether property for which an amount of more than $500 is claimed is for a related use, the donee must explain any such intended use of such property. A penalty of $10,000

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[183] Present law rules continue to apply to any contribution of exempt use property for which a deduction of $5,000 or less is claimed.

[184] The disposition proceeds are regarded as relevant to a determination of fair market value.

applies to a person that identifies property as related use property knowing that it is not intended for such use.[185]

The proposal modifies the present-law information return requirements that apply upon the disposition of contributed property by a charitable organization (Form 8282, sec. 6050L). For property identified by the donee organization on the Form 8283 as exempt use property, the return requirement is extended to dispositions made within three years after receipt (from two years). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether the property was used to substantially further exempt purposes, a certification of any such use (described above).

Effective Date

With respect to contributions of taxidermy property, the proposal is effective for contributions made after the date of enactment. With respect to exempt use property generally, the proposal is effective for contributions made after June 1, 2006.

15. Limit charitable deduction for contributions of clothing and household items and modify recordkeeping and substantiation requirements for certain charitable contributions

Present Law

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[186] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[187] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt

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[185] Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

[186] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[187] Secs. 170(b) and (e).

organizations generally are not deductible by the donor,[188] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. 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 are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[189] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above). If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is basis. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Substantiation

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the

[188] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

[189] For certain contributions of inventory and other property, 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. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.[190] A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.[191]

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of $250 or more. No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.[192] In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[193] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

Description of Proposal

General rule relating to clothing and household items

The proposal requires the Secretary to prepare and publish an itemized list of clothing and household items and to assign an amount to each item on the list. The assigned amount is treated as the fair market value of the item for purposes of the charitable contribution deduction and is based on an assumption that the item is in good used condition or better. Any deduction for a charitable contribution of each such item may not exceed the item's assigned amount. Any deduction for an item not in good used condition or better may not exceed 20 percent of the item's assigned amount. Any deduction for an item that is not functional with respect to the use for which it was designed is not allowed.

The list must be published by the Secretary at least once each calendar year and is applicable to contributions of clothing and household items made while the list is effective. The

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190 Treas. Reg. sec. 1.170A-13(a).

191 Treas. Reg. sec. 1.170A-13(b).

192 Sec. 170(f)(8).

193 Sec. 170(f)(11).

Secretary has discretion to determine the effective dates for each published list. The list should be prepared in consultation with donee organizations that accept charitable contributions of clothing and household items. In assigning amounts to particular items, the Secretary should take into account the sales price of such contributed items when sold by the donee organizations, whether through an exempt program of such organizations or otherwise. If an item of clothing or a household item is not included on the list published by the Secretary, present law rules apply to the contribution of the item.

The proposal does not apply to contributions by C corporations. The proposal applies to new and used items. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food is not considered a household item. Paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the proposal.

Substantiation

Clothing and household items

As under present law, for contributions with a claimed value of $250 or more, the taxpayer must obtain contemporaneous substantiation from the donee organization, which must include a description of the property contributed. The proposal provides that, as part of such substantiation, the taxpayer obtain an indication of the condition of the item(s) and the number and type of items of clothing and household items contributed and either a copy of the published list or instructions as to how to find such list.

Under present law, if a taxpayer claims that the total value of charitable contributions of noncash property is more than $500, the taxpayer must include with the taxpayer's return a description of the property contributed and such other information as the Secretary may require in order to claim a charitable deduction (sec. 170(f)(11)(B)). This requirement presently is satisfied through completion by the taxpayer of the Form 8283 and attachment of the form to the taxpayer's return. The proposal requires that the donor include the information about the contribution that is contained in the contemporaneous substantiation obtained from the donee organization (for gifts of $250 or more) as part of such requirement.

Contributions of $100 or more

Under the proposal, the substantiation requirements that currently apply with respect to charitable contributions of $250 or more (sec. 170(f)(8)) apply to all charitable contributions with a value of $100 or more.

Contributions of cash

In addition, in the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied under the proposal only if the donor maintains a cancelled check or a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records.

Effective Date

The proposal relating to clothing and household items is effective for contributions made after January 1, 2007. The proposal relating to substantiation more generally is effective for contributions made in taxable years beginning after the date of enactment.

16. Contributions of fractional interests in tangible personal property

Present Law

In general, a charitable deduction is not allowable for a contribution of a partial interest in property, such as an income interest, a remainder interest, or a right to use property.[194] A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[195] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[196] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[197]

Consistent with these requirements, a charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[198] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[199] Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, "[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally

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[194] Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

[195] Sec. 170(f)(3)(B)(ii).

[196] Treas. Reg. sec. 1.170A-7(b)(1).

[197] Treas. Reg. sec. 1.170A-7(b)(1).

[198] Sec. 170(a)(3).

[199] Treas. Reg. sec. 1.170A-5(a)(4).

executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year."[200]

Description of Proposal

Require consistent valuation of fractional interests in the same item of property

In general, under present law and the proposal a donor may take a deduction for a charitable contribution of a fractional interest in tangible personal property (such as an artwork), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of interests in the same property.[201] Under the proposal, a donor's charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) shall be determined as under current law (e.g., based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee's exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, under the proposal, the fair market value of the item shall be the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. This portion of the proposal applies for income, gift, and estate tax purposes.

Require actual possession by the donee

The proposal provides for recapture of the income tax charitable deduction or gift tax charitable deduction under certain circumstances. Specifically, if, during any one-year period following a contribution of a fractional interest in an item of tangible personal property, the donee fails to take actual possession of the item for a period of time corresponding substantially to the donee's then-existing percentage interest in the item, then the donee's charitable deduction for all previous contributions of interests in the item shall be recaptured (plus interest).

Under the proposal, the Secretary of the Treasury is authorized to promulgate rules to prevent the circumvention of the proposal by, for example, engaging in a transaction in which a donor first transfers one or more items of tangible personal property to a separate entity in exchange for ownership interests in the entity, and subsequently makes charitable contributions of such ownership interests.

Effective Date

The proposal is applicable for contributions made after the date of enactment.

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[200] Treas. Reg. sec. 1.170A-5(a)(2).

[201] See, e.g., *Winokur v. Commissioner*, 90 T.C. 733 (1988).

17. Provisions relating to substantial and gross overstatement of valuations of property

Present Law

Taxpayer penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[202] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

In addition, the accuracy-related penalty does not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.[203]

Penalty for aiding and abetting understatement of tax

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

Qualified appraisals

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[204] Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of

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[202] Sec. 6662(b)(3) and (h).

[203] Sec. 6664(c).

[204] Sec. 170(f)(11).

contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[205]

Qualified appraisers

Treasury Regulations define a qualified appraiser a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.[206]

Appraiser oversight

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").[207] After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

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[205] Treas. Reg. sec. 1.170A-13(c)(3).

[206] Treas. Reg. sec. 1.170A-13(c)(5)(i).

[207] 31 U.S.C. sec. 330.

Description of Proposal

Taxpayer penalties

The proposal lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required. Under the proposal, a substantial valuation misstatement exists when the claimed value of donated property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value of donated property is 200 percent or more the amount determined to be the correct value. Under the proposal, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

Appraiser oversight

Appraiser penalties

The proposal establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the proposal, the penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.

Disciplinary proceeding

The proposal eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who have been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Qualified appraisers

The proposal defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.

Qualified appraisals

The proposal defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the proposal) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

Effective Date

The proposal amending the accuracy-related penalty applies to returns filed after the date of enactment. The proposal establishing a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns filed after the date of enactment. The proposals relating to appraiser oversight apply to returns filed after the date of enactment.

18. Expand the base of the tax on private foundation net investment income

Present Law

In general

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,[208] also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[209] Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

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[208] *See* sec. 4947(a)(1).

[209] Sec. 4940(e).

Net investment income

Internal Revenue Code

In general, net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.[210]

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.[211]

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and no capital loss carryovers are allowed.[212]

Treasury Regulations and case law

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.[213]

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.[214] Such additional items include payments with respect to securities loans (an item added to the Code in 1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.[215] These latter three categories of income are not enumerated as net investment income in the Code.

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[210] Sec. 4940(c)(1). Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income). Sec. 4940(c)(5).

[211] Sec. 4940(c)(2).

[212] Sec. 4940(c)(4).

[213] Treas. Reg. sec. 53.4940-1(d)(1).

[214] *Id.*

[215] Treas. Reg. sec. 1.512(b)-1(a)(1).

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that "gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded."[216] As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation's exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that "property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities)."[217]

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that "generally produces" certain types of income. By contrast, the Code provides that the property be "used" to produce such income. In *Zemurray Foundation v. United States*, 687 F.2d 97 (5th Cir. 1982), the taxpayer foundation challenged the Treasury's attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation's use of the phrase "generally used," though permitting taxation "so long as the property sold is *usable* to produce the applicable types of income, regardless of whether the property is actually used to produce income or not" was not unreasonable or plainly inconsistent with the statute.[218] However, on remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.[219] Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

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216 Treas. Reg. sec. 53.4940-1(f)(1).

217 *Id.*

218 *Zemurray Foundation v. United States*, 687 F.2d 97, 100 (5th Cir. 1982).

219 *Zemurray Foundation v. United States*, 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account *only* gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties . . . ."[220] The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After *Zemurray*, the Treasury generally conceded this issue.[221]

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.[222]

<u>Application of *Zemurray* to the Code and the regulations</u>

Applying the *Zemurray* case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of *Zemurray*, if a foundation provided office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.[223]

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[220] *Zemurray Foundation v. United States*, 755 F.2d 404 (5th Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A).

[221] G.C.M. 39538 (July 23, 1986).

[222] Treas. Reg. sec. 53.4940-1(f)(3).

[223] *See also* the example in Treas. Reg. sec. 53.4940-1(f)(1).

In addition, under the logic of *Zemurray*, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

Description of Proposal

The proposal amends the definition of gross investment income to include certain items of income not presently enumerated in the Code but identified in Treasury regulations, namely, income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments. In addition, the capital gains and losses subject to the tax are modified to include capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

The proposal provides that there are no carrybacks of losses from sales or other dispositions of property.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

19. Establish additional exemption standards for credit counseling organizations

Present Law

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65-299,[224] an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

In Revenue Ruling 69-441,[225] the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that

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[224] Rev. Rul. 65-299, 1965-2 C.B. 165.

[225] Rev. Rul. 69-441, 1969-2 C.B. 115.

ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.[226] The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69-441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt management plans.[227] The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of $10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.[228]

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.[229] During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 during 2000 to 2003.[230] The IRS has recognized more than 850 credit

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[226] Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

[227] *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

[228] *See also*, *Credit Counseling Centers of Oklahoma, Inc., v. U.S.*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

[229] Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[230] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,*

counseling organizations as tax exempt under section 501c)((3).[231] Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.[232] As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.[233]

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.[234] Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).[235] Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,[236] such as the Federal Trade Commission

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Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

[231] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[232] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[233] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

[234] *E.g.*, The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq.*, effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

[235] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[236] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004.

Act.[237] In addition, the IRS has commenced a broad examination and compliance program with respect to the credit counseling industry, pursuant to which the IRS has initiated audits of 50 credit counseling organizations, including nine of the 15 largest in terms of gross receipts.[238]

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, an individual generally may not be a debtor in bankruptcy unless such individual has, within 180 days of filing a petition for bankruptcy, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlines the opportunities for available credit counseling and assists the individual in performing a related budget analysis.[239] The clerk of the court must maintain a publicly available list of nonprofit budget and credit counseling agencies approved by the U.S. Trustee (or bankruptcy administrator). In general, the U.S. Trustee (or bankruptcy administrator) shall only approve an agency that demonstrates that it will provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides. The minimum qualifications for approval of such an agency include: (1) in general, having an independent board of directors; (2) charging no more than a reasonable fee, and providing services without regard to ability to pay; (3) adequate provision for safekeeping and payment of client funds; (4) provision of full disclosures to clients; (5) provision of adequate counseling with respect to a client's credit problems; (6) trained counselors who receive no commissions or bonuses based on the outcome of the counseling services; (7) experience and background in providing credit counseling; and (8) adequate financial resources to provide continuing support services for budgeting plans over the life of any repayment plan. An individual debtor must file with the court a certificate from the approved nonprofit budget

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[237] 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

[238] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 31.

[239] This requirement does not apply in certain circumstances, such as: (1) in general, where a debtor resides in a district for which the U.S. Trustee has determined that the approved counseling agencies for such district are not reasonably able to provide adequate services to additional individuals; (2) where exigent circumstances merit a waiver, the individual seeking bankruptcy protection files an appropriate certification with the court, and the certification is acceptable to the court; and (3) in general, where a court determines, after notice and hearing, that the individual is unable to complete the requirement because of incapacity, disability, or active military duty in a military combat zone.

and credit counseling agency that provided the required services describing the services provided, and a copy of the debt management plan, if any, developed through the agency.[240]

Description of Proposal

Requirements for exempt status of credit counseling organizations

Under the proposal, an organization that provides credit counseling services as a substantial purpose of the organization ("credit counseling organization") is eligible for exemption from Federal income tax only as a charitable or educational organization under section 501(c)(3) or as a social welfare organization under section 501(c)(4), and only if (in addition to present-law requirements) the credit counseling organization is organized and operated in accordance with the following:

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer.

2. The organization makes no loans to debtors and does not negotiate the making of loans on behalf of debtors,

3. The organization is generally does not provide or promote any service for the purpose of (a) improving any consumer's credit record, credit history, or credit rating;

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, and prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the agency's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling agency or its affiliates) and (c) not more than 49% of the voting power of which is vested in persons who are employed by the

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[240] The Act also requires that, prior to discharge of indebtedness under chapter 7 or chapter 13, a debtor complete an approved instructional course concerning personal financial management, which course need not be conducted by a nonprofit agency.

organization or who will benefit financially, directly or indirectly, from the agency's activities (other than through the receipt of reasonable directors' fees);

7. The organization receives no amount for providing referrals to others for financial services (including debt management services) to be provided to consumers, and pays no amount to others for obtaining referrals of consumers; and

8. The organization is not related to an organization in the business of credit repair, to a person that is in the business of lending money, or to a person that provides debt management plan services, payment processing, and similar services. Additional requirements for charitable or educational organizations.

Additional requirements for charitable and educational organizations

Under the proposal, a credit counseling organization is described in section 501(c)(3) only if, in addition to satisfying the above requirements, the organization is organized and operated such that the organization (1) charges no fees (other than nominal fees) for debt management plan services and waives any fees if payment of such fees would work a financial hardship; (2) does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization; (3) normally limits debt management plan services (in the aggregate) to 25 percent of the organization's total activities (determined by taking into account time, resources, source of revenues or effort expended by the organization, and any other measures prescribed by the Secretary).[241] The 25-percent limit shall be applied with regard only to the activities of the credit counseling organization, and without regard to the activities of any affiliates, separately organized entities, or entities that, together with the credit counseling organization, are covered by a group exemption determination letter. The Secretary is authorized to promulgate rules designed to prevent circumvention of this requirement.

Additional requirements for social welfare organizations

Under the proposal, a credit counseling organization is described in section 501(c)(4) only if, in addition to satisfying the above requirements applicable to such organizations, it is organized and operated such that the organization charges no fees (other than nominal fees) for its credit counseling services, and waives any fees if payment of such fees would work a financial hardship. In addition, a credit counseling organization shall not be treated as an organization described in section 501(c)(4) unless such organization applies for recognition of exempt status under procedures similar to those described in section 508(a) (applicable to section 501(c)(3) organizations).

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[241] If, under any such measure, the organization's debt management plan services exceed 25 percent of the organization's total activities, the organization is treated as exceeding the 25-percent limit. For example, an organization that devotes 30 percent of its total staff time to debt management plan services is regarded as exceeding the 25-percent limit, even if the organization devotes less than 15 percent of its total financial resources to debt management plan services.

Debt management plan services treated as an unrelated trade or business

Under the proposal, debt management plan services as treated as an unrelated trade or business for purposes of the tax on income from an unrelated trade or business to the extent such services are not substantially related to the provision of credit counseling services to a consumer or are provided by an organization that is not a credit counseling organization.

Definitions

Credit counseling services

Credit counseling services are (a) the providing educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit; (b) the assisting of individuals and families with financial problems by providing them with counseling; or (c) any combination of such activities.

Debt management plan services

Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.

Credit repair organization

A credit repair organization is one defined in section 403(3) of the Consumer Credit Protection Act, 15 U.S.C. 1679a(3), without regard to subparagraph (B) thereof.

Related person

A person is treated as related to another person if such person bears a relationship to such other person described in section 4958(f)(1)(B), section 4958(f)(1)(C), or section 4946(a)(1)(H)(i).

Effective Date

For organizations that are not described in section 501(c)(3) or section 501(c)(4) prior to the date of enactment or that are so described but did not provide credit counseling services prior to such date, the proposal is effective for taxable years beginning after the date of enactment. For organizations described in section 501(c)(3) or 501(c)(4) prior to the date of enactment that provided credit counseling services prior to such date, the proposal is effective for taxable years beginning 1 year after the date of enactment. The Secretary has authority to request information from an organization providing credit counseling services to ensure that the organization is in compliance with the proposal.

20. Impose loan and redemption requirements on pooled financing bonds

Present Law

In general

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of such bonds are used to finance direct activities of governmental units or if such bonds are repaid with revenues of governmental units. These bonds are called "governmental bonds." Interest on State or local government bonds issued to finance certain activities of private persons is taxable unless a specific exception applies. These bonds are called "private activity bonds." 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. In addition, the Code imposes requirements that apply to all tax-exempt State and local bonds. Arbitrage restrictions, for example, limit the ability of issuers to profit from investment of tax-exempt bond proceeds. The Code also imposes requirements that only apply to specific types of bond issues. For instance, pooled financing bonds (defined below) are not tax-exempt unless the issuer meets certain requirements regarding the expected use of proceeds.

Pooled financing bond restrictions

At times, State or local bonds are issued to provide financing for the benefit of a third party (a "conduit borrower"). Pooled financing bonds are issues in which the proceeds are used to make or finance loans to two or more conduit borrowers, unless the conduit loans are to be used to finance a single project.[242] The Code imposes several requirements on pooled financing bonds if more than $5 million of proceeds are expected to be used to make loans to conduit borrowers. For purposes of these rules, a pooled financing bond does not include certain private activity bonds.[243]

A pooled financing bond is not tax-exempt unless the issuer reasonably expects that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue. The term "net proceeds" is defined to mean the proceeds of the issue less the following amounts: (1) proceeds used to finance issuance costs; (2) proceeds necessary to pay interest on the bonds during a three-year period; and (3) amounts in reasonably required reserves.[244]

An issuer's past experience regarding loan origination is a criterion upon which the reasonableness of the issuer's expectations can be based. As an additional requirement for tax exemption, all legal and underwriting costs associated with the issuance of pooled financing

[242] Treas. Reg. sec. 1.150-1(b).

[243] Sec. 149(f)(4)(B).

[244] Sec. 149(f)(2)(C).

bonds may not be contingent and must be substantially paid within 180 days of the date of issuance.

Arbitrage restrictions on tax-exempt bonds

To prevent the issuance of more Federally subsidized tax-exempt bonds than necessary, the tax exemption for State and local bonds does not apply to any arbitrage bond.[245] 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. 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 ("arbitrage rebate").

The Code contains several exceptions to the arbitrage rebate requirement, including an exception for bonds issued by small governments (the "small issuer exception"). For this purpose, small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[246]

Pooled financing bonds are subject to the arbitrage restrictions that apply to all tax-exempt bonds, including arbitrage rebate. Under certain circumstances, however, small governments may issue pooled financing bonds without those bonds counting towards the determination of whether the issuer qualifies for the small issuer exception to arbitrage rebate. In the case of a pooled financing bond where the ultimate borrowers are governmental units with general taxing powers not subordinate to the issuer of the pooled bond, the pooled bond does not count against the issuer's $5 million limitation, provided the issuer is not a borrower from the pooled bond.[247] However, the issuer of the pooled financing bond remains subject to the arbitrage rebate requirement for unloaned proceeds.[248]

Description of Proposal

In general

The proposal imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the proposal imposes a written loan commitment requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified ("blind pools"). Second, in addition to the current three-year expectations requirement, the issuer must

[245] Secs. 103(a) and (b)(2).

[246] The $5 million limit is increased to $15 million if at least $10 million of the bonds are used to finance public schools.

[247] Sec. 148(f)(4)(D)(ii)(II).

[248] Treas. Reg. sec. 1.148-8(d)(1).

reasonably expect that at least 50 percent of the net proceeds of the pooled financing bond will be lent to borrowers one year after the date of issue. Third, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the proposal eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled financing bonds for purposes of determining whether the issuer qualifies for the small issuer exception to rebate.

Loan commitments

Under the proposal, interest on a pooled financing bond is tax exempt only if the issuer obtains written commitments with ultimate borrowers for loans equal to at least 50 percent of the net proceeds of the pooled bond prior to issuance. For purposes of the proposal, a loan commitment exists only if: (a) the issuer is committed to lend bond proceeds to the borrower identified in the commitment, and (b) the borrower has applied for, and agreed to execute, a loan in an amount certain to finance a specifically identified project and, as part of that application, has paid a nonrefundable commitment fee in an amount that is commensurate with fees customarily paid for similar loan commitments.

The loan commitment requirement does not apply to bonds issued by States (or an integral part of a State) to provide loans to subordinate governmental units or State entities created to provide financing for water-infrastructure projects through the Federally-sponsored State Revolving Fund Program.

Loan origination expectations

The proposal imposes new reasonable expectations requirements for loan originations. The issuer must expect that at least 50 percent of the net proceeds of the pooled financing bond will be lent to ultimate borrowers one year after the date of issue. This is in addition to the present-law requirement that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue.

Redemption requirement

Under the proposal, if bond proceeds are not loaned to borrowers within prescribed periods, outstanding bonds equal to the amount of proceeds that were not loaned within the required period must be redeemed within 90 days. The bond redemption requirement applies with respect to proceeds that are unloaned as of expiration of the one-year and three-year loan origination periods. For example, if an amount equal to 45 percent of the net proceeds of an issue are used to make loans to ultimate borrowers as of one year after the bonds are issued, an amount equal to five percent of the net proceeds of the issue is no longer available for lending and must be used to redeem bonds within the following 90-day period. Similarly, if only 85 percent of the net proceeds of the issue are used to make qualifying loans (or to redeem bonds) as of three years after the bonds are issued, 10 percent of the remaining net proceeds is no longer available for lending and must be used to redeem bonds within the following 90-day period.

Small issuer exception

The proposal eliminates the rule disregarding pooled financing bonds from the issuer's $5,000,000 annual limitation for purposes of the small issuer exception to arbitrage rebate.

Effective Date

The proposal is effective for bonds issued after the date of enactment.

21. Amend information reporting requirements to include interest on tax-exempt bonds

Present Law

Tax-exempt bonds

Generally, 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 the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in 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 purposes ("qualified private activity bonds") permitted by the Code.

Tax-exempt interest reporting by taxpayers

The Code provides that every person required to file a return must report the amount of tax-exempt interest received or accrued during any taxable year. The amount of tax-exempt interest received is relevant to determining tax liability in a number of instances, despite the general exclusion from income. For example, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[249] Tax-exempt interest also is relevant for determining eligibility for the earned income credit (the "EIC") and the amount of Social Security benefits includable in gross income. Moreover, determining includable Social Security benefits is necessary for calculating either adjusted or modified adjusted gross income under several Code sections.

Information reporting by payors

The Code generally requires every person who makes payments of interest aggregating $10 or more or receives payments of interest as a nominee and who makes payments aggregating $10 or more to file an information return setting forth the amount of interest payments for the

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[249] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.

calendar year and the name, address, and TIN[250] of the person to whom interest is paid. Treasury regulations prescribe the form and manner for filing interest payment information returns. Treasury regulations require the reporting of the account or serial number, or other identifying information with respect to obligations on which interest is paid. The regulations also require that every person acting as a middleman (e.g., a broker) file information returns for the calendar year. Penalties are imposed for failures to file interest payment information returns or payee statements. Treasury regulations also impose recordkeeping requirements on any person required to file information returns. The Code excludes interest paid on tax-exempt bonds from interest reporting requirements.[251]

Description of Proposal

Under the proposal, interest paid on tax-exempt bonds is subject to information reporting in the same manner as interest paid on taxable obligations.

Effective Date

The proposal is effective for interest paid after December 31, 2005.

22. Modification of credit for fuel from a non-conventional source

Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[252] per barrel or Btu oil barrel equivalent ("non-conventional source fuel credit"). Qualified fuels must be produced within the United States.

Qualified fuels include:

- oil produced from shale and tar sands;
- gas produced from geopressured brine, Devonian shale, coal seams, tight formations, or biomass; and
- liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Generally, the non-conventional source fuel credit has expired, except for certain biomass gas and synthetic fuels sold before January 1, 2008, and produced at facilities placed in service

[250] The taxpayer's identification number, generally, for individuals is the taxpayer's social security number. Sec. 7701(a)(41).

[251] Sec. 6049(b)(2)(B).

[252] Generally, the value of the credit in 2004 was $6.56 per barrel-of-oil equivalent produced, which is approximately $1.16 per thousand cubic feet of natural gas. The credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979.

after December 31, 1992, and before July 1, 1998. The non-conventional source fuel credit provision also includes a credit for producing coke or coke gas at qualified facilities. The amount of credit-eligible coke produced at any one facility may not exceed an average barrel-of-oil equivalent of 4,000 barrels per day.

The non-conventional source fuel credit is reduced (but not below zero) over a $6 phase-out period as the reference price for oil exceeds $23.50 per barrel, adjusted for inflation. The reference price is the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil. The credit did not phase-out for 2004 because the reference price for that year of $36.75 did not exceed the inflation adjusted threshold of $51.35.

Beginning with taxable years ending after December 31, 2005, the non-conventional source fuel credit is part of the general business credit (sec. 38).

Description of Proposal

The proposal modifies the manner in which the phase-out of the non-conventional source fuel credit is calculated. Specifically, in calculating the phase-out of the credit rather than relying upon the reference price for the calendar year in which the sale of qualified non-conventional fuel occurs, the proposal uses the reference price for the calendar year preceding the calendar year in which the sale occurs. Thus, under the proposal, whether the credit is phased out in 2005 is determined by reference to 2004 wellhead prices, whether the credit is phased out in 2006 is determined by reference to 2005 wellhead prices, and so on. In addition, the proposal repeals the phase-out limitation entirely for coke and coke gas produced under section 45K(g).

The proposal eliminates the inflation adjustment for all fuels other than coke and coke gas for 2005, 2006, and 2007. Thus, the current credit amount of $6.56 per barrel of oil equivalent will remain in effect through the December 31, 2007. Under the proposal, the credit amount of $3 per barrel of oil equivalent for coke and coke gas produced under section 45K(g) would continue to be adjusted for inflation using 2004 as the base year.

Finally, the proposal clarifies that qualifying facilities producing coke or coke gas under section 45K(g) do not include facilities that produce petroleum-based coke or coke gas.

Effective Date

The proposal is effective for fuel sold after December 31, 2004.

23. Modification of individual estimated tax safe harbor

Present Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments equal to the lesser of: (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. For taxpayers with a prior year's AGI above $150,000, however, the rule that allows payment of 100 percent of prior year's

tax is modified. Those taxpayers with AGI above $150,000 generally must make estimated payments equal to the lesser of (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the prior year's tax.

Description of Proposal

First, the proposal provides that taxpayers with prior year's AGI above $150,000 who make estimated tax payments based on prior year's tax must do so based on 119 percent of prior year's tax for estimated tax payments made for taxable year 2006. That percentage will revert back to 110 percent for taxable years 2007 and thereafter.

Effective Date

The proposal is effective for estimated tax payments made for taxable years beginning after December 31, 2005.

24. Time for payment of corporate estimated taxes

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Description of Proposal

With respect to corporate estimated tax payments due on September 15, 2010, 3 percent is required to be paid on October 1, 2010.

Effective Date

The proposal is effective on the date of enactment.

25. Extension and modification of new markets tax credit

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").[253] 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. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at

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

its original issue, and is available for a taxable year 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. 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 ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

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. 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. 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.

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 (rather than 80 percent) of statewide median family income. 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 has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "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, 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.[254] Under such Act, a targeted

[254] 12. U.S.C. 4702(17) (defines "low-income" for purposes of 12. U.S.C. 4702(20)).

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, 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 such business is used in a low-income community; (3) a substantial portion of the services performed for such 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 such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at $2.0 billion per year for calendar years 2004 and 2005, and at $3.5 billion per year for calendar years 2006 and 2007.

Description of Proposal

The proposal permits for 2008 a $3.5 billion maximum annual amount of qualified equity investments. The proposal also requires that the Secretary prescribe regulations to ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments.

Effective Date

The proposal is effective on the date of enactment.

26. Expansion of Hope and Lifetime Learning Credits for students in the Gulf Recovery Zone

Present Law

Hope credit

The Hope credit is a nonrefundable credit of up to $1,500 per 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.[255] The Hope credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000

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[255] Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

($87,000 and $107,000 for married taxpayers filing a joint return) for 2005.[256] The first adjustment to these amounts as a result of inflation is expected in 2006. Thus, for example, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the adjusted gross income phaseout) for a $1,000 Hope credit. If an eligible student incurs $2,000 or more of qualified tuition and related expenses, then he or she is eligible for a $1,500 Hope credit.

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 the first three months of the next 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 (described below), or the section 222 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

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[256] The adjusted gross income phase-out ranges are indexed for inflation. Also, each of the $1,000 amounts of qualified tuition and related expenses to which the 100-percent credit rate and 50 percent credit rate apply are indexed for inflation, with the amount rounded down to the next lowest multiple of $100.

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. In order to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

For taxable years beginning in 2004 and 2005, the Hope credit offsets the alternative minimum tax. For taxable years thereafter, the Hope credit does not offset the alternative minimum tax.

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

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.[257] Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

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[257] Sec. 25A. The Lifetime Learning credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

In contrast to the Hope credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family -- that is, the Hope credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005. These phaseout ranges are the same as those for the Hope credit, and are similarly indexed for inflation.

The Lifetime Learning 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 the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. As with the Hope credit, repayment of a loan is not a qualified tuition expense.

As with the Hope credit, a taxpayer may claim the Lifetime Learning credit with respect to a 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 by the parent or other taxpayer, the student may not claim the Lifetime Learning 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 the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a Hope credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the Hope credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses.

As with the Hope credit, the Lifetime Learning 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 a student at the institution. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. 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 expenses unless this education is part of the student's degree program, or the education is undertaken to acquire or improve the job skills of the student.

In contrast to the Hope credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.[258] Additionally, in contrast to the Hope credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

As with the Hope credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees 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 fees 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 during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning 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.

For taxable years beginning in 2004 and 2005, the Lifetime Learning credit offsets the alternative minimum tax. For taxable years thereafter, the credit does not offset the alternative minimum tax.

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

Description of Proposal

The proposal temporarily expands the Hope and Lifetime Learning credits for students attending (i.e., enrolled and paying tuition at) an eligible education institution located in the Gulf Recovery Zone.

Under the proposal, the Hope credit is increased to 100 percent of the first $2,000 in qualified tuition and related expenses and 50 percent on the next $2,000 of qualified tuition and related expenses for a maximum credit of $3,000 per student. The Lifetime Learning credit rate is increased from 20 percent to 40 percent. The proposal expands the definition of qualified expenses to include expenses associated with books, transportation, and room and board (as defined in section 529).

The proposal applies to taxable years beginning in 2005 or 2006.

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[258] As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education.

Effective Date

The proposal is effective on the date of enactment.

27. Restructure New York Liberty Zone tax incentives

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[259]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.[260] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

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

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[261] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4)

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

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

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

computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property[262] and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[263] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.[264]

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

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[265] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Depreciation of New York Liberty Zone 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.[266] This rule applies regardless of whether the lessor or the

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

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

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

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

[266] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of

lessee places the leasehold improvements in service.[267] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.[268]

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

Increased section 179 expensing for qualified New York Liberty Zone property

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct the cost of qualifying property. For taxable years beginning in 2003 through 2007, a taxpayer may deduct up to $100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property for this purpose is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The $100,000 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 $400,000. The $100,000 and $400,000 amounts are indexed for inflation.

For taxable years beginning in 2008 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. In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

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

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

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

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

Qualifying property for purposes of the NYLZ provision means section 179 property[269] purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.[270]

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

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

Extended replacement period for New York Liberty Zone involuntary conversions

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[271] The replacement period is extended

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

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

[271] Section 1033(a)(2)(B).

to three years if the converted property is real property held for the productive use in a trade or business or for investment.[272]

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

Description of Proposal

Repeal of certain NYLZ incentives

The proposal repeals the four NYLZ incentives relating to the additional first-year depreciation allowance of 30 percent, the five-year depreciation of leasehold improvements, the additional section 179 expensing, and the extended replacement period for involuntary conversions.[273]

Creation of New York Liberty Zone Tax Credits

The proposal provides a credit against tax imposed (other than taxes of section 3111(a), 3403, or subtitle D) paid or incurred by any governmental unit of the State of New York and the City of New York equal to the lesser of (1) the total expenditures during such year by such governmental unit for qualifying projects, or (2) the amount allocated to such governmental unit for such calendar year.

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

The aggregate limit that may be allocated for all calendar years in the credit period is two billion dollars. The annual limit for any calendar year in the credit period shall not exceed the sum of 200 million dollars plus the aggregate amount authorized to be allocated for all preceding calendar years in the credit period which was not allocated. The credit period is the ten-year period beginning on January 1, 2006.

If, at the close of the credit period, the aggregate amounts allocated are less than the 2 billion dollar aggregate limit, the Governor of the State of New York and the Mayor of the City of New York may jointly allocate, for any calendar year following the credit period, for

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[272] Section 1033(g)(4).

[273] The proposal does not change the present-law rules relating to certain NYLZ private activity bond financing and additional advance refunding bonds.

expenditures with respect to qualifying projects, amounts that in sum for all years following the credit period would equal such shortfall.

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

Effective Date

The proposal is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law. The extended replacement period for involuntarily converted property ends on the earlier of (1) the date of enactment or (2) the last day of the five-year period specified in the Jobs Creation and Worker Assistance Act of 2002 ("JCWAA").[274]

28. Treatment of S corporation passive investment income

Present Law

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

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[274] Pub. Law No. 107-147, sec. 301 (2002).

Description of Proposal

The proposal increases the 25-percent threshold to 60 percent and eliminates the rule terminating an S election by reason of having passive investment income for three consecutive taxable years.

Effective Date

The proposal applies to taxable years beginning after December 31, 2005.

29. Revaluation of LIFO inventories of large integrated oil companies

Present Law

A taxpayer is generally permitted to use a last-in, first-out (LIFO) method to inventory goods, on the condition that the taxpayer also uses the LIFO method in reporting to shareholders, partners, other proprietors, and beneficiaries, and for credit purposes.[275] Under the LIFO method, a taxpayer (i) treats goods on hand at the close of the taxable year as being: first, those goods included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year; (ii) inventories the goods at cost; and (iii) treats those goods included in the opening inventory of the taxable year in which the LIFO method was first used as having been acquired at the same time, and determines their cost by the average cost method.[276]

In periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the start of the period, and carries such total inventory cost forward to the beginning inventory of the following year.

In periods during which the taxpayer sells more goods than the taxpayer produces or purchases (an inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or the most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

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[275] Sec. 472(c).

[276] Sec. 472.

Description of Proposal

The proposal disallows a portion of the benefit of the LIFO method to integrated oil companies[277] with gross receipts in excess of $1 billion for the relevant taxable year.

Specifically, the proposal requires such taxpayers to revalue each historic LIFO layer of crude oil inventories by adding to each layer an amount equal to 75 percent of the increase in the price of crude oil between the end of the most recent taxable year of the taxpayer ending in 2005, and the date which is twelve months prior to the end of such taxable year, multiplied by the number of barrels of crude oil represented by such LIFO layer; the taxpayer must reduce its cost of sales for such taxable year by a like amount.

For example, suppose a taxpayer, which is an integrated oil company with revenues in excess of $1 billion, has a 2005 starting inventory of 200 barrels, comprised of a 1955 LIFO layer with 50 barrels valued at $5 per barrel (with a total cost of $250); a 1985 LIFO layer with 100 barrels valued at $18 per barrel (with a total cost $1800); a 2000 LIFO layer with 30 barrels valued at $25 per barrel (with a total cost of $750), and a 2004 LIFO layer with 20 barrels valued at $35 per barrel (with a total cost $700), for a total inventory value of $3500. Suppose further that the price of oil over the relevant period has risen $26.67 per barrel (e.g., from $34 per barrel to $60.67 per barrel). Suppose further that the taxpayer's ending inventory is 200 barrels, i.e., the same as the starting inventory, so the taxpayer has neither an inventory increment nor an inventory decrement for the taxable year.

Under the proposal, the taxpayer will revalue each LIFO layer upwards by $20/barrel (i.e., 75% of $26.67). Thus, the taxpayer will increase its 1955 LIFO layer by $1000; its 1985 LIFO layer by $2000; its 2000 LIFO layer by $600; and its 2004 LIFO layer by $400. The taxpayer will offset this $4000 increase in inventory by reducing by $4000 the taxpayer's costs of goods sold for the most recent taxable year ending in 2005.

Effective Date

The proposal is effective for the most recent taxable year of relevant taxpayers ending in 2005.

30. Capital expenditure limitation for qualified small issue bonds

Present Law

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single

[277] The proposal defines an "integrated oil company" by cross-reference to section 291(b)(4), which generally includes retailers and large refiners of oil or natural gas or any product derived from oil or natural gas.

borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located.

For bonds issued after September 30, 2009, the Code permits up to $10 million of capital expenditures to be disregarded, in effect increasing from $10 million to $20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county.[278] However, no more than $10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other limits (e.g., the $40 million per borrower limit) also continue to apply.

Description of Proposal

The proposal accelerates the application of the $20 million capital expenditure limitation from bonds issued after September 30, 2009, to bonds issued after December 31, 2006.

Effective Date

The proposal is effective on the date of enactment for bonds issued after December 31, 2006.

[278] Sec. 144(a)(4)(G) as added by sec. 340(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).