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Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

Before discussing 2005 tax legislation, bills passed late in 2004 after the publication of the *2004 University of Illinois Federal Tax Workbook* must be discussed.

AMERICAN JOBS CREATION ACT OF 2004

This major tax bill was passed October 11, 2004. A supplement to the *2004 University of Illinois Federal Tax Workbook* was prepared and discussed at the 2004 tax workshops. This supplement can be downloaded at **www.ace.uiuc.edu/Taxschool/PDF/AmericanJobsCreationAct-ch14a.pdf.**

A number of energy provisions are contained in the American Jobs Creation Act (AJCA). In light of the Energy Bill, discussed later, these provisions deserve additional discussion.

DYED DIESEL FUEL

Diesel fuel and kerosene are typically taxed when removed from a terminal. However, if the fuel is used for certain purposes, it is exempt from the fuel excise tax. These purposes include:

- Farming,
- State or local government operations,
- Vehicles owned by an aircraft museum, and
- School buses.

In order to prevent the use of untaxed diesel fuel for non-tax-exempt purposes, exempt diesel is dyed red. This makes it easy to detect when the untaxed diesel is found in the tank of a non-tax-exempt vehicle.

Certain IRS employees have the responsibility of detecting the illegal use of untaxed fuel. These employees take samples of fuel from diesel vehicles. The penalty for violating the diesel excise tax rules is $1,000 per incident or $10 per gallon. The penalty is multiplied for multiple violations.

In order to avoid detection, some violators have found ways to remove the red dye from untaxed fuel. AJCA now imposes penalties for tampering with dye injection systems. The penalty is the greater of $25,000 or $10 per gallon of fuel involved. Terminals who fail to properly secure their dying equipment are subject to a $1,000 penalty and an additional $1,000 per-day penalty for each day the equipment is left unsecured after the first date the violation occurs.

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ALCOHOL FUEL AND BIODIESEL MIXTURES EXCISE TAX CREDIT

A federal excise tax is imposed when fuel is removed from a refinery or terminal. The tax is equal to 18.4¢ per gallon of gasoline and 24.4¢ per gallon on kerosene and diesel fuel. To encourage the use of ethanol or methanol mixtures, AJCA reduced the excise tax rate on these mixtures. For example, the rate for a 10% ethanol mixture in 2004 was 13.3¢ per gallon.

Biodiesel is a liquid derived from vegetable oils or animal fat. It is suitable for use in a diesel powered highway vehicle, but it is not treated as diesel fuel because it contains less than 4% normal paraffins. Biodiesel is taxed if it is sold as fuel for a diesel powered highway vehicle or diesel powered train. Biodiesel may also be blended with regular diesel fuel. There is no reduced tax rate for biodiesel fuel.

The new law eliminates the reduced excise tax rates.

HANDLING THE NEW BIODIESEL FUELS CREDIT[1]

AJCA authorized a new nonrefundable income tax credit for biodiesel fuels, which is actually the sum of two credits: the "biodiesel mixture credit" and the "biodiesel credit." The resulting credit is treated as a general business credit. The biodiesel fuels credit is added to the list of qualified business credits that qualify for a deduction if they remain unused at the end of the applicable carryforward period.

The biodiesel fuels credit applies to fuel produced and sold or used after December 31, 2004, and expires for sales and uses after December 31, 2008.[2] The biodiesel fuels credit is included in gross income.

For pass-through entities, the biodiesel fuels credit passes through and is apportioned between an estate or trust and its beneficiaries.

In late 2004, the IRSA published guidance on the biodiesel fuels credit.[3]

Nature of the Credit

Effective January 1, 2005, AJCA provided for a credit of 50¢ per gallon of biodiesel "used by the taxpayer in the production of a qualified biodiesel mixture." The credit is called the biodiesel mixture credit. A qualified "biodiesel mixture" is defined as a mixture of biodiesel and diesel fuel, without regard to use of kerosene, which is:

- Sold by the taxpayer producing the mixture to any person for use as a fuel, or
- Used as a fuel by the taxpayer producing the mixture.

To qualify for the biodiesel mixture credit, the mixture's **sale or use must be in the taxpayer's trade or business,** and the biodiesel must be taken into account for the tax year in which the sale or use occurs. No credit is allowed for "casual off-farm production" of a qualified biodiesel mixture.

The biodiesel credit is another type of credit. This credit is 50¢ per gallon for each gallon of **biodiesel that is not in a mixture with diesel fuel** and is:

- Used by the taxpayer as a fuel in a trade or business, or
- Sold by the taxpayer at retail to a person and placed in the tank of the retail purchaser's vehicle.

Such fuel is often referred to as 100% biodiesel or B100. No biodiesel credit is allowed for any biodiesel sold in a **retail sale** that is not in a mixture with diesel fuel.

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1. The following is reprinted by permission of the author, Neil E. Harl, from *Ag Law Digest,* May 6, 2005, Vol. 16 No. 9.
2. As extended by the Energy Policy Tax Act of 2005
3. IRS Notice 2005-4, December 15, 2004

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A special rule applies to "agri-biodiesel." In that case, the biodiesel mixture credit or the biodiesel credit is set at $1 per gallon, rather than 50¢ per gallon. The term "agri-biodiesel" is defined in terms of the source of the oils including corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, and animal fats.

A claim may be taken only once for any particular gallon of alcohol or biodiesel.

Claiming the Credit

To claim the biodiesel credit or the biodiesel mixture credit, the taxpayer must obtain a certification from the producer (or importer) of the biodiesel identifying the product produced and the percentage of biodiesel and agri-biodiesel in the product. The IRS published model certification forms.

The biodiesel fuels credit is claimed on Form 8864, *Biodiesel Fuels Credit.*

A credit is allowed against the tax imposed on taxable fuel. The credit is equal to the sum of the alcohol fuel mixture credit and the biodiesel mixture credit. The credit is allowable to the person who produces the mixture for sale or use in the producer's trade or business. The credit is claimed on Form 720, *Quarterly Federal Excise Tax Return.*

To the extent the sum of the alcohol fuel mixture and biodiesel mixture credit exceeds a person's IRC §4081 liability for any quarter, an income tax credit or payment is allowable to the producer of the mixture. The credit is also claimed on Form 720, or Form 8849, *Claim for Refund of Excise Taxes.*

Recapture of the Credit

If a credit was claimed for the retail sale of biodiesel and any person mixes the biodiesel or uses the biodiesel other than as a fuel, a tax is imposed on that person. The amount of tax is the per-gallon rate originally used to compute the biodiesel credit multiplied by the number of gallons of biodiesel.

Coordination with Excise Tax Credit

The biodiesel fuels credit is also coordinated with the excise tax credit allowed under newly enacted IRC §§6426 and 6427(e). The amount of the biodiesel fuels credit determined for any biodiesel is reduced to take into account any benefit claimed for the biodiesel under the excise tax credit provision.

> **Observation.** These credits are designed to increase the use of agricultural commodities. The increased use of the commodity effectively increases the price of the commodity. In addition, it reduces reliance on fossil fuels.

SMALL ETHANOL PRODUCER CREDIT PASS-THROUGH

A cooperative (co-op) is generally considered a pass-through entity. They distribute profits to their patrons in the form of a patronage dividend. The dividend is taxable to the patron and deductible to the co-op. However, prior to AJCA, the small ethanol producer credit could not be passed through to patrons.

Under AJCA, the co-op can elect to pass the credit to patrons, prorated based on the quantity or value of business done by the cooperative with each patron for the year.

The credits are included in the patron's gross income as patronage dividends. The patron (not the co-op) claims the credit. The credit can only be claimed if income from the credit is declared in the same tax year.

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Example 1. Farmer Smith received a Form 1099-PATR reporting total patronage dividends of $1,000 from OurAg Cooperative. He also received a $300 Small Ethanol Producer Credit pass-through from the same cooperative. He must show $1,300 of patronage dividends on his Schedule F in order to claim the $300 credit.

Note. The pass-through treatment must be elected by the cooperative on a timely filed return. Once made, the election is irrevocable. AJCA does not specify how this election is made.

If the pass-through credit amount is reduced for any reason, the co-op, **not the patrons,** is responsible for the increase in tax. This increase to the co-op may not be reduced by other tax credits and is not treated as a tax for AMT purposes.

WORKING FAMILIES TAX RELIEF ACT OF 2004

The Working Families Tax Relief Act of 2004 (WFTRA) was signed into law on October 4, 2004. The act contained tax cuts for both individuals and businesses.

EXTENDERS

Many of the provisions of this act simply extended previous tax provisions that were due to expire at the end of 2003. These provisions were extended until the end of 2005. At the time of publication, it is not known if Congress will extend the provisions beyond 2005. However, there is a bill before Congress which would extend many of these provisions. Tax provisions that were extended through December 31, 2005, include the following:

- Availability of Archer medical savings accounts (MSAs)
- Donations of qualified computers, enhanced deduction
- Expensing of environmental remediation costs
- Offset of personal credits against regular tax and AMT
- Renewable electricity production credit
- Repeal of deduction phaseout for qualified clean-fuel vehicles
- Repeal of credit phaseout for qualified electric vehicles
- Research credit
- Tax incentives for investment in District of Columbia
- Teacher's classroom expenses, above-the-line deduction
- Welfare-to-work credit
- Work opportunity credit
- Authority to issue New York Liberty Advance Refunding Bonds

One provision, the authority to issue New York Liberty Bonds, was extended through December 31, 2009.

EXPANSION OF 10% TAX BRACKET

The 10% tax bracket was due for reduction after December 31, 2004. WFTRA retains the $14,000 limit for joint filers and the $7,000 limit for single filers through December 31, 2010. The 10% tax bracket for single filers is maintained at $7,000 ($10,000 for heads of household) through 2010 as well. Beginning in 2011, there will be no 10% tax bracket.

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MARRIAGE PENALTY RELIEF

The basic standard deduction for joint filers and surviving spouses will remain at 200% of the amount of single filers through 2010. In addition, the 15% tax bracket will remain at 200% of the single filer amount through 2010.

CHILD TAX CREDIT

The child tax credit which was scheduled for reduction will remain at $1,000 per child through 2010 after which it will return to $500 in 2011. This is a per-child credit. As of 2004, the credit is refundable to the extent of 15% of the taxpayer's taxable earned income in excess of $10,750. This income level will be indexed for inflation.

AMT EXEMPTION

The AMT exemption was also extended through 2005. The exemption is $58,000 for joint filers and surviving spouses and $40,250 for other taxpayers.

UNIFORM DEFINITION OF A QUALIFYING CHILD

In an attempt to simplify existing tax law, Congress included a uniform definition of a child in the tax act. Under the old law, taxpayers received tax benefits from children in various ways. These benefits included the following:

- Dependency exemption
- Child tax credit
- Earned income credit
- Dependent care credit
- Head of household filing status

Unfortunately, each applicable benefit used different criteria to identify what qualified the child. **Prior to January 1, 2005, five tests had to be met to qualify as a dependent:**

1. Over 50% of the dependent's support had to be provided by the taxpayer claiming the dependency exemption.
2. The dependent had to reside in the taxpayer's home or be related to the taxpayer.
3. The dependent had to be a U.S. citizen or national, or a resident of the United States, Canada, or Mexico at some time during the calendar year.
4. The gross income of the dependent for the calendar year had to be less than the exemption amount. If the dependent was the child of the taxpayer and was under age 19 or a student under age 24, this test was waived.
5. The dependent could not file a joint tax return.

The new bill establishes a **uniform definition of a qualifying child** for all the above benefits. A child is a qualifying child of the taxpayer if the child has:

1. The same principal abode as the taxpayer for more than half of the taxable year,
2. A specific relationship to the taxpayer,
3. Not reached a specific age, and
4. Not provided over one-half of her own support (does not pertain to EIC).

A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the new law, the old support and gross income tests used in determining dependency do not apply if the uniform definition of a qualifying child is met. However, the citizenship and joint return tests still apply.

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1. Residency Test

The new law requires the qualifying child to have the same abode as the taxpayer for **more than half** of the year. Temporary absences due to special circumstances, such as illness, education, business, vacation, or military service are not intended to be treated as absences. If a child is legally adopted, but is not a citizen of the United States, he qualifies as long as he resides in the taxpayer's residence and the taxpayer is a U.S. citizen or national.

2. Relationship Test

The qualifying child must be the taxpayer's:

- Son or daughter,
- Stepson or stepdaughter,
- Brother or sister,
- Stepbrother or stepsister, or
- A descendent from any of the above individuals.

A child who is legally adopted by the taxpayer or a child who is lawfully placed with the taxpayer for legal adoption is treated as a child by blood. Foster children qualify if they are placed in the home by an authorized placement agency.

> **Note.** See Example 18 in Chapter 1, "Individual Taxpayer Problems," for more information on claiming the dependency exemption for adopted children in 2005 and later years.

3. Age Test

The age test varies depending on the benefit involved. Normally, a child must be under age 19 (or under age 24 for a full-time student) in order to be a qualifying child for purposes of the dependency exemption, earned income credit, and head of household filing status. No age limit applies for individuals who are totally and permanently disabled at any time during the year. For the dependent care credit, a child must be under age 13, unless disabled. For the child credit, the child must be under age 17, whether disabled or not.

4. Children Who Support Themselves

Generally, a child who supports himself is not considered a qualifying child of any other person. This rule does not apply for the purposes of qualifying the other person for the earned income credit.

Tie-Breaking Rules

The tie-breaking rules only apply if there is a **dispute** among those taxpayers for whom the child is a qualifying child. An example is when a child lives with both his mother and his father. When a dispute occurs, the following are used to determine who claims the dependency exemption for the qualifying child.

1. If the taxpayer who claims the dependency exemption is the child's parent, the child is deemed the "qualifying child" of the parent.
2. If both parents claim the child and the parents do **not** file a joint tax return:
   - The parent with whom the child resides the longest claims the child's exemption.
   - If the time period is equal for both parents, the parent with the highest AGI claims the child's exemption.
3. If neither of the child's parents claim the child's exemption, the child is the "qualifying child" of the person with the highest AGI with whom the child resides.

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For taxpayers who claim a dependency exemption for an individual not meeting the uniform definition of a qualifying child, there is no change to the old law. For example, a taxpayer may claim a parent as a dependent if the prior dependency tests are met.

A grandparent may claim a dependency exemption for a grandchild who does not reside with the grandparent for over half of the year if:

- The child is not a **qualifying child** for any other person,
- The grandparent can prove he furnished more than half of the child's support,
- The child's gross income is less than the exemption amount,
- The child meets the citizenship test, and
- The child does not file a joint return.

Children of Divorced or Legally Separated Parents

There is only slight modification to the current law for children of divorced parents. The custodial parent may still waive the right to claim the dependency exemption by properly completing Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*. In addition, the noncustodial parent is entitled to the dependency exemption when it is allocated to him within a state divorce decree.[4]

Example 2. Lyle and Margo Edwards were divorced in 2002. The state divorce decree contained a clause which stated:

For purposes of both federal and state income tax returns of the divorcing parties for the 2002 and later tax years, the dependency exemption of the minor child of the divorcing parties, Lisa, is awarded to Lyle Edwards, the noncustodial parent.

Question 2A. Under the new provisions of the WFTRA, which of Lisa's parents is entitled to claim her dependency exemption for the 2005 tax year?

Answer 2A. Lyle Edwards, the noncustodial parent. This is true even if Margo, his ex-wife, refused to properly execute a Form 8332 to release Lisa's exemption for 2005.

Note. See the *Omans* Tax Court case in the "Dependency Issues" section of Chapter 13, "Rulings and Cases" for more information on this noncustodial parent provision.

Because the child tax credit rules require that the child be claimed as a dependent, the parent who is entitled to the child's dependency exemption is automatically entitled to the credit for the child. However, under the new law, a custodial parent who does not claim a child's dependency exemption, due to signing Form 8332 or due to provision in a divorce decree, may still be entitled to the following for the child:

- Earned income credit
- Dependent care credit on Form 2441, *Child and Dependent Care Expenses*
- Head of household filing status

4. IRC §152(e)(2), as amended in October 2004 by WFTRA

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Effect of New Law

Dependency Exemption. The qualifying child test eliminates the gross income and support tests, except for a child who provides more than half of his own support. These tests were replaced with a residency test.

If a dependent does not meet the requirements of a qualifying child, the dependency exemption is still allowed if the individual is a "qualifying relative."[5]

To be a qualifying relative, a person must meet the following tests:

1. **Relationship to taxpayer.** The individual must be one of the following:
   - Child or descendant of child
   - Brother, sister, stepbrother, or stepsister
   - Father or mother or an ancestor of either
   - Stepfather or stepmother
   - Son or daughter of a brother or sister of the taxpayer
   - Brother or sister of the taxpayer's parent
   - Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law (a relationship established by marriage is not dissolved by divorce)
   - An individual who lives in the same home with the taxpayer for the entire tax year
2. **Gross income is less than the exemption amount.**
3. **The taxpayer must provide over one-half of the support.**
4. **The person must not be a qualifying child of the person or any other taxpayer.**
5. **The person must meet the citizenship and joint return tests.**

Earned Income Credit. The definition of a qualifying child is similar to the old law. The requirement that a foster child or certain other children must be cared for as the taxpayer's own child was eliminated. The present tie-breaker rule applicable for the earned income credit is used for purposes of the uniform definition of a qualifying child.

Child Tax Credit. The same relationships are used under both the old and the new law. The requirement that a taxpayer must care for a foster child as his own was dropped. There is no change to the under-17-years-of-age requirement, regardless of whether the child is disabled.

Dependent Care Credit. The new law eliminates the requirement that the taxpayer maintain a household in order to claim the credit. Therefore, if other requirements are met, a taxpayer can claim the dependent care credit if the qualifying child lives with the taxpayer more than half the year, even if the taxpayer does not provide more than half the cost of maintaining the household.

Head of Household Status. Under the new law, a taxpayer is eligible for the head of household filing status only if providing a home for an **unmarried qualifying child or** a qualified individual for whom the taxpayer can claim a dependency exemption. A taxpayer may claim head of household status if unmarried (and not a surviving spouse) and paying more than half the cost of maintaining the household which is the principal residence of the qualifying child or dependent for more than half the year. Dependents who are not qualifying children must meet the same requirements as under the old law.

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5. IRC §152(d)(1)(D)

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Note. Under the old law, the parent only needed to furnish over half the cost of maintaining a home for a single child who lived with the parent to qualify for head of household filing status. The new law requires the child be a qualifying child or a qualifying relative claimed as a dependent.

Example 3. Doris provides a home for her son, Scott, age 36. Scott earns $10,000 per year, but does not contribute to the household expenses. Under the old law, Doris could claim head of household status. Under the new law, Scott is too old to be a qualifying child and makes too much money to be claimed as a qualified relative. Therefore, Doris can no longer claim head of household status.

Example 4. Benjamin, Zoey, and Arlene have lived in Benjamin's home since 2003. Benjamin and Zoey are not married. Arlene, age five, is Zoey's daughter. Arlene is not Benjamin's daughter. Neither Zoey nor Arlene have any income in 2004 or 2005 and are totally supported by Benjamin. In 2004, Benjamin filed as head of household because Arlene met the five-prong test as a dependent. Benjamin could also claim both Zoey and Arlene as dependents in 2004.

In 2005, Benjamin claims Zoey as a dependent because she meets the definition of a qualified relative for purposes of the dependency test. However, Benjamin cannot claim Arlene. She is not his qualifying child, because they are unrelated. Unlike Zoey, she fails the qualifying relative test. Under the four-prong test for a qualifying child, Arlene is the qualifying child of Zoey. As such, Arlene is not a qualifying relative for Benjamin.

Benjamin cannot file as head of household in 2005. Arlene is neither a qualifying child nor can she be claimed as a dependent. While Zoey can be claimed as a dependent, she fails the definition of qualified relative for head of household purposes, which specifically excludes unrelated people who live with the taxpayer for 12 months.

Effective Date

The uniform definition of a qualifying child rules are effective for years beginning after December 31, 2004.

Note. The uniform definition rules do not apply to a child who files a joint return. The prior-law rules apply for individuals to whom the uniform definition rules do not apply.

Other Uniform Definition Situations

Prior to the new definition, a child was generally defined as the taxpayer's child or stepchild. The new expanded definition also applies to the following:

1. Dependent care credit, or employer-paid dependent care
2. Early distribution penalty exclusion for retirement payment distributions used to pay higher education expenses of the taxpayer's child
3. Treatment of the employee's child as an employee for purposes of the exclusion for qualifying fringe benefits
4. The tests for a married taxpayer to be treated as unmarried
5. Hope and Lifetime learning credits
6. Deduction for medical expenses
7. Withholding exemptions

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Qualifying as another person's dependent disqualifies the individual from claiming the personal exemption. This is true even if the other person does **not** claim the person as a dependent. The IRS ruled that a college student was not entitled to claim a personal exemption because the student qualified as the parents' dependent, even though the parents did not claim the dependency deduction.[6]

Exceptions to the New Definition

Some areas of the tax code are not affected by the new definition of a qualifying child if the only reason the person does not qualify is because they:

- File a joint return,
- Claim dependency exemptions, or
- Have gross income in excess of the exemption amount.

The following are just some of these exceptions:

1. The head of household filing status

   Example 5. Janice is a student at the University of Kentucky. She lives with her mother when she is not in school. She earns $6,000 at her summer job. While she fails the gross income test, she still qualifies her mother for the head of household filing status if she is under age 24 and remains a full time student.

2. The exception from the early distribution from a qualified retirement plan
3. The exception which allows amounts paid to maintain certain students in the taxpayer's home to qualify as a charitable contribution
4. The exclusion of a distribution from a medical savings account from income

> **Note.** The changes made to the definition of a dependent do not affect the determination of excludible employer-provided insurance coverage for a taxpayer's dependent.

DISASTER MITIGATION PAYMENTS

On April 15, 2005, the President signed into law P.L. 109-7, enacting IRC §139(g). This provision excludes payments received as qualified disaster mitigation payments from income. Prior to §139(g), these payments were considered taxable income.[7]

Mitigation payments[8] are payments made to allow a taxpayer to take actions to prevent property damage from future disasters. Since the payments are excluded from income, they do not increase the basis of the property. The payments are not allowed to provide a double deduction or credit.

Example 6. Travis and Stacy live in the flood plain of the Mississippi River. They receive a flood mitigation payment to pay for placing their house on stilts to prevent damage from future floods. These payments can be excluded from income.

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6. Letter Ruling 200236001, December 18, 2001
7. IRS Chief Counsel Advice 200431012, July 30, 2004
8. Under the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act

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ACCELERATE TAX BENEFITS FOR CHARITABLE CASH CONTRIBUTIONS FOR RELIEF OF THE VICTIMS OF THE INDIAN OCEAN TSUNAMI

Under P.L. 109-1, passed by the legislature on January 11, 2005, taxpayers are allowed to deduct charitable cash contributions for aid to the victims of the Indian Ocean Tsunami. While contributions are normally deductible in the year made, cash contributions to the victims were deductible on the taxpayer's 2004 tax return if paid by January 31, 2005.

If the taxpayer chooses, he can deduct the contribution on the 2005 return; however, the contributions cannot be deducted in both years.

BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

Bankruptcy filings have increased dramatically since 1990. In 1990, there were only 782,960 filings regardless of type. This increased to 1,597,462 in 2004.[9] Some estimate bankruptcies cost the average consumer over $400 per year in increased cost of merchandise. Much of the discharged debt in bankruptcies is owed to credit card companies. Consequently, Congress has come under considerable pressure to modify the bankruptcy laws.

This bill was signed into law by the President on April 20, 2005. It is the largest bankruptcy reform bill since 1978. While this is not considered a tax bill, there are tax aspects to the bill which are discussed in this section. These changes are not in the Internal Revenue Code, but are contained in the Bankruptcy Code. The new bankruptcy laws became effective on October 17, 2005.

The act makes some major changes in how tax obligations are treated in bankruptcy. Chapter 13 plans no longer allow a "super discharge." The priority of taxes during bankruptcy proceedings was changed. There are also new notice requirements. Some of the changes basically favor the IRS and other taxing authorities by giving them increased authority and additional protection.

Other changes favor the debtor. IRAs are now protected from creditors. A set and uniform rate of interest on tax liabilities and quicker set-offs of refunds and liabilities are included in the act.

BANKRUPTCY CHAPTERS

The various types of bankruptcy are referred to as chapters. Depending on the bankruptcy chapter under which the taxpayer files, transactions receive different treatment.

Chapter 7 Bankruptcy

This is often referred to as "straight bankruptcy" or "liquidation." Chapter 7 allows individuals to easily free themselves from debt. Certain property is exempt from the individual's creditors, but all other assets are liquidated and the proceeds go to the creditors to repay debt. Most unsecured debt is canceled in the bankruptcy proceeding.

Typically, the bankrupt has few assets that will be lost in the bankruptcy. The procedure may be over in as little as four months, giving the bankrupt a relatively fast "fresh start" since most debts are discharged in the bankruptcy proceeding. The most common reasons individuals file for bankruptcy is unemployment, extensive medical expenses, seriously overextended credit, marital problems, and other large unexpected expenses.

Individual Chapter 7 debtors, but not partnerships or corporations, qualify for a separate tax entity which opens up more tax planning opportunities.

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9. U.S. Bankruptcy Court Table F-2 for 1990 and 2004

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Chapter 11 Bankruptcy

Chapter 11 is primarily a restructuring plan designed to allow businesses to continue operating. It establishes a payment plan for the creditors. The business may be able to get out from under a burdensome lease or contract and unsecured debt. While the business continues to operate, it does so under the supervision of the Bankruptcy Court and its appointees. The business may operate under Chapter 11 for several months or several years.

As with individual Chapter 7 filers, those filing under Chapter 11 are also eligible for separate entity status.

Chapter 12 Bankruptcy

Chapter 12 bankruptcy is a special provision for family farms which have regular annual income. It calls for a three- to five-year plan. It allows for reorganization similar to Chapter 13.

Neither Chapter 12 or Chapter 13 filers are eligible for a new tax entity, but a 2005 change in Chapter 12 rules provide some new tax planning opportunities, as discussed later.

Major Developments.[10] In the most far-reaching revision of bankruptcy law since 1978,[11] Congress passed and the President signed legislation making major changes in bankruptcy law.[12] For agriculture, the changes are principally in two areas:

1. Amendments to the eligibility requirements for Chapter 12 filing
2. Modification of the income tax treatment of gains on property liquidated in connection with a Chapter 12 bankruptcy reorganization

A third major area of importance is that the homestead exemption is limited to $125,000 if the debtor purchased the residence less than three years and four months (defined as 1215 days) before filing.[13] There are exceptions for:

1. The residence of a "family farmer," and
2. Any amount rolled over from another residence acquired by the debtor before the 1215-day period, provided the prior and current residences are located in the same state.[14]

Eligibility Requirements. Perhaps the most significant features of the new legislation are that it makes Chapter 12 bankruptcy permanent[15] and extends the provisions of Chapter 12 to a "family fisherman,"[16] although with different requirements imposed for eligibility. The definition of the term "family farmer" is changed to allow an individual, or an individual and spouse, engaged in a farming operation to have aggregate debts not to exceed $3,237,000 (up from $1.5 million under prior law)[17] with not less than 50% of the aggregate, noncontingent, liquidated debts (excluding the debt from a principal residence) arising out of a farming operation (down from 80% under prior law).[18] Moreover, the requirement that more than 50% of gross income must be received from a farming operation the taxable year preceding filing has been relaxed to allow the 50% test to be met, in the alternative, during the second and third tax years preceding filing.[19] Thus, a Chapter 12 filer must have more than 50% of its gross income from farming in either

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10. The following is reprinted by permission of the authors, Harl, Peiffer and McEowen, from *Ag Law Digest,* April 22, 2005, Vol. 16 No. 8.
11. Bankruptcy Reform Act of 1978, P.L.95-598, 92 Stat. 2459 (1978). See Harl, *Agricultural Law*, Ch. 120 (2005); Harl, *Agricultural Law Manual*, §13.03 (2005).
12. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong., 1st Sess. (2005), hereinafter referred to as the Act. Codified as P.L.109-8, 119 Stat 23.
13. Act, §322, 109th Cong., 1st Sess. (2005), amending 11 U.S.C. §522(o), (p), (q)
14. Ibid
15. Act, §1001, 109th Cong., 1st Sess. (2005)
16. Act, §1007, adding 11 U.S.C. §101(19A) and expanding the definition of "who may be a debtor" in 11 U.S.C. §109(f)
17. Act, §1004, amending 11 U.S.C. §101(18)(A), (B)
18. Ibid
19. Act, §1005, amending 11 U.S.C. §101(18)(A)

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the tax year prior to filing **or in both** the second and third tax years prior to filing the Chapter 12 petition.[20] The dollar requirements are also to be adjusted for inflation at three-year intervals.[21]

The requirements imposed on a "family fisherman" remain the same as those imposed on "family farmers" before the 2005 amendments. That is, aggregate debts cannot exceed $1.5 million; not less than 80% of the aggregate noncontingent, liquidated debt must arise out of a commercial fishing operation; and the 50% gross income test must be met during the taxable year preceding filing.[22]

The 2005 act does not impose the 50% gross income test on otherwise eligible partnerships and corporations for family farmers.[23] That was believed to have been an omission in the 1986 legislation enacting Chapter 12[24] but it was not changed in the 2005 amendments.[25]

Post-petition Taxes. The legislation contains a new provision of immense potential importance to Chapter 12 filers.[26] That provision allows a Chapter 12 debtor to treat claims arising out of "claims owed to a governmental unit" as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" to be treated as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, **provided the debtor receives a discharge.**[27]

> **Note.** Nothing in the legislation specifies when the property can be disposed of in order to be eligible for unsecured claim status. Of course, the taxing agencies must receive at least as large an amount as they would have received had the claim been a pre-petition unsecured claim. The key point is that, under prior law, taxes were a priority claim and had to be paid in full.[28]

Even though the priority tax claims could be paid in full in deferred payments under prior law,[29] in many instances the debtor did not have sufficient funds to allow payment of the priority tax claims in full even in deferred payments.

This amendment addresses a major problem faced by many family farmers filing under Chapter 12 where the sale of assets to make the operation economically viable triggered gain which, as a priority claim, had to be paid.[30]

20. Ibid
21. 11 U.S.C. §104(b)(1)
22. Act, §1007, adding 11 U.S.C. §101(19A)
23. See Act, §1004, amending 11 U.S.C. §101(18)(B)
24. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, P.L. 99-554, 100 Stat. 3105 (1986), adding 11 U.S.C. §1201 *et seq*
25. Act, §1004, 1005, amending 11 U.S.C. §101(18)(B)
26. Act, §1003, amending 11 U.S.C. §1222(a)
27. Act, §1003, amending 11 U.S.C. §1222(a)(2) by the addition of subsection (A)
28. 11 U.S.C. §507(a) and §1222(a)(2)
29. 11 U.S.C. §1222(a)(2)
30. *In re Specht*, No. 96-21022KD (Bankr. N.D. Iowa (decided April 9, 1997))

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Operationally, if a Chapter 12 bankruptcy filer has liquidated assets used in the farming operation within the tax year of filing or liquidates assets used in the farming operation after Chapter 12 filing as part of the Chapter 12 plan, and gain or depreciation recapture income or both are triggered, the plan should provide that there will be no payments to unsecured creditors until the amount of the tax owed to governmental bodies for the sale of assets used in the farming operation is ascertained. The tax claims[31] are then added to the pre-petition unsecured claims to determine the percentage distribution to be made to the holders of pre-petition unsecured claims, as well as the claims of the governmental units that are being treated as unsecured creditors not entitled to priority. With that approach, all claims that are deemed to be unsecured claims would be treated equitably.

Arguably, if a debtor determined postconfirmation that, to ensure financial and economic viability, assets used in the farming operation must be liquidated, the Chapter 12 plan could be modified to allow the sale of assets as long as the modified plan made provision to make payments to the taxing bodies in an amount that would equal or exceed what would have been received had it been a pre-petition unsecured claim. Upon entry of the Chapter 12 discharge, the claim of the governmental body for taxes on the sale of assets used in the farming business would also be discharged. If the debtor does not receive a Chapter 12 discharge, the taxing bodies are free to pursue the debtor as if no bankruptcy had been filed, assessing and collecting the tax and all penalties and interest allowed by law.

The 2005 act also specifies that a Chapter 12 plan may provide for less than full payment of all amounts owed for a claim entitled to priority under 11 U.S.C. Sec. 507(a)(1)(B) (a higher priority classification for domestic support obligations assigned to governmental units) **if** the plan provides that all of the debtor's projected disposable income for a five-year period will be applied to make payments under the plan beginning on the date that the first payment is due under the plan.[32]

The 2005 act also adds a new provision requiring an individual Chapter 12 debtor to be current on postpetition domestic support obligations as a condition of confirmation of a plan.[33]

Effective Dates. Except as otherwise provided, the amendments made by the Act are effective 180 days after enactment, the date of the President's signature.[34] However, the provision making Chapter 12 bankruptcy a permanent part of the Bankruptcy Code is effective July 1, 2005.[35]

The bill also specifies that, except as otherwise provided, the amendments do not apply to cases commenced under Title 11 of the United States Code (the bankruptcy provisions) before the effective date of the act.[36] The amendments made by Sections 308, 322, and 330 apply for cases commenced under Title 11 on or after the date of enactment of the act.[37]

The Chapter 12 tax provisions (Section 1003 of the act) are effective upon enactment,[38] as is the homestead exemption provision.[39]

Conclusion. The 2005 amendments make highly important changes to Chapter 12 bankruptcy. The changes involving the possible conversion of taxes on the sale of assets used in the farming operation to the status of pre-petition unsecured claims are particularly notable.

> **Note.** The date of enactment is April 20, 2005.

31. 11 U.S.C. §1222(a)(2)
32. Act, §213, amending 11 U.S.C. §1222(a)(4)
33. Act, §213, amending 11 U.S.C. §1225(a)
34. Act, §1501(b)(1)
35. Act, §1001
36. Act, §1501(b)(1)
37. Act, §1501(b)(2)
38. 11 U.S.C. §1222(a)(2)(A)
39. 11 U.S.C. §522(o), (p), (q)

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Chapter 13 Bankruptcy

Chapter 13 bankruptcy is often referred to as the "wage earner" plan. The plan gives the taxpayer a longer time to repay debts, typically three to five years. Chapter 13 appeals to taxpayers who have nonexempt property they wish to keep. However, Chapter 13 is only an option for taxpayers who have sufficient predictable income to repay their debts during the time period allowed and cover their normal expenses.

PROVISIONS GIVING ADDITIONAL PRIORITY AND PROTECTION

To understand the changes, the words "discharge" and "priority" must be defined. Debts which are discharged in bankruptcy are forgiven. Therefore the taxpayer is no longer liable for these obligations. To determine which debts are discharged, the debts are ranked by priority. The higher the priority of the debt, the less chance it has of being fully or partially discharged. Generally, tax debts incurred within three years of bankruptcy are given priority status and are not eligible for discharge.

Some courts have discharged tax debts incurred within three years of filing, but this is rare. If a taxpayer fails to file a tax return, the tax liability is normally not dischargeable, even after three years. However, some courts have discharged these liabilities as well. Tax debts arising from fraudulent returns are not generally dischargeable. However, some courts have allowed them to be discharged. This practice is known as "superdischarge." The new law prevents these tax debts from being discharged.

The timing of filing a claim can cause a tax liability to lose its priority status. Under the new law, tax claims can be filed within a longer window of time.

CREDITOR PROTECTION FOR IRA ACCOUNTS

The treatment of retirement plans has been a controversial issue in bankruptcy cases. Under the new law, retirement savings accounts are exempt from the bankruptcy estate. These retirement accounts must be in a tax-favored account or fund.[40] There is a $1 million limitation for IRA accounts rolled over from qualified plans, which are protected without a dollar limitation. Loans from these plans are excluded from discharge.

Roth IRAs have not been protected in the past. They are protected under the new bill. However, the new law does not go into effect until 180 days after enactment. This means Roth IRAs are not protected if the bankruptcy is filed before October 17, 2005.

Education IRAs and §529 plans are also included in the new law. They are exempt up to $5,000 if the funds are deposited between 720 and 365 days before the filing date. No protection is given for funds deposited within the year prior to filing bankruptcy.

HOMESTEAD EXEMPTION

The Bankruptcy Abuse Prevention and Consumer Protection Act addresses the amount of the homestead exemption. In some states, the entire value of the homestead is an exempt asset protected from creditors. Consequently, this was an area of abuse in those states. The new law limits the amount of the homestead exemption in certain instances:

1. If the debtor sells non-exempt property and reinvests it in the homestead in an attempt to hinder, delay, or defraud a creditor within 10 years prior to filing, then the available homestead exemption is effectively reduced by the amount that the value of the homestead is attributable to the transaction.

Example 7. P. J. Stimpson lost a civil suit in February 1997. In March of that year, he sold several paintings for $500,000 and used that money to build a room addition onto his new Florida home. In December of 2005, he filed for bankruptcy. His Florida home is worth $1.3 million at the time he files.

Under the new law, if the court finds that the sale and investment were done with the intent to keep assets from creditors, the court can limit the value of his home that is protected from creditors to $800,000.

40. This included accounts under IRC §§ 401, 403, 408, 408A, 414, 414, 457, and 501(a).

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2. If any interest in a homestead is acquired within 1,215 days of filing (roughly three years and four months,) the amount of the acquisition available to be excluded is limited to $125,000.

> **Note.** The court does not have to find "intent" to impose this limit.

Example 8. Kendra Lay purchases a home in Texas for $200,000 in January of 2003. The home was purchased with money Kendra inherited. In January of 2006, she files for bankruptcy. The value of her home protected from creditors is limited to $125,000 because the purchase was made within 1,215 days of filing.

> **Note.** This provision does not apply to family farms or to amounts "rolled over" from the sale of previous residence in the same state.

3. If any of the following apply, the homestead exemption is limited to $125,000:
   - The debtor is convicted of a felony, which under the circumstances, demonstrates that the filing was an abuse of the bankruptcy laws, or
   - The debtor owes debt arising from:
     - Violations of the Securities Exchange Act or similar laws,
     - RICO civil penalties, or
     - Criminal acts, intentional tort, or reckless misconduct causing serious physical injury or death to another individual in the preceding five years.

This provision does not apply to the extent that the value in excess of $125,000 is reasonably necessary for the support of the debtor or his dependents.

TAX COMPLIANCE

The courts require more paperwork from the bankruptcy filer. All tax returns of taxpayers seeking Chapter 13 protection must be filed. The taxpayer must file the last four years' pre-petition tax returns before the first creditors' meeting. The meeting will be held open if the returns are not filed. However, the additional time may not exceed 120 days after the date of the meeting.

ENERGY TAX INCENTIVES ACT OF 2005 AND SAFE TRANSPORTATION EQUITY ACT OF 2005

OVERVIEW

The Energy Tax Incentives Act of 2005 (ETIA), which is part of the larger Energy Policy Act of 2005, provides $14.5 billion in tax incentives over the next 10 years. The primary beneficiaries of these incentives are traditional energy interests such as coal, oil, natural gas, and utilities. However, there are also provisions that benefit alternative fuel sources of energy such as wind, ethanol, biodiesel, and nuclear. The individual taxpayer is also able to receive incentives for conserving energy by making his home more energy efficient. These measures include insulation, solar water heaters, energy efficient windows, and the like.

The following discussion focuses on the provisions most likely to affect individuals and small businesses. However, tax professionals should be aware that some clients will invest in pass-through entities and receive Schedule K-1 forms reporting credits from some of the provisions which are not discussed. ETIA contains 1,724 pages and is too voluminous to discuss in detail in this workbook.

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The act is divided into five major areas. The areas and the projected incentives are as follows:

- Energy efficiency and conservation measures $2.7 billion
- Renewable and clean energy incentives $2.9 billion
- Clean coal $2.9 billion
- Electricity reliability $3.1 billion
- Oil and gas production and enhancing refining $2.6 billion

Two days after signing the Energy Bill, the President signed the SAFE Highway Transportation Act of 2005. Many of these provisions intertwine with the Energy Bill. The provisions are combined in the following discussion.

ENERGY EFFICIENCY AND CONSERVATION MEASURES

Alternative Motor Vehicle Credit

Currently, the only incentive encouraging the development of alternative fuels is the deduction for certain costs of clean-fuel vehicles. These are vehicles using clean-burning fuels and include hybrid-electric vehicles but not qualified electric vehicles. Clean-burning fuels include:

- Natural gas,
- Liquefied natural gas,
- Liquefied petroleum gas,
- Hydrogen,
- Electricity, and
- Other fuel of which at least 85% of the content is methanol, ethanol, any other alcohol, or ether.

The current deduction is:

- $50,000 for a truck or van with a gross vehicle weight (GVW) over 26,000 lbs. or a bus with at least a 20 adult seating capacity,
- $5,000 for a truck or van with a GVW between 10,000 and 26,000 lbs., and
- $2,000 for any other motor vehicle.

Under the old law, these deductions were reduced by 65% in 2006 and terminated for years thereafter. The new law terminates the deduction for vehicles placed in service after December 31, 2005.

ETIA creates several tax credits designed to encourage development of alternative fuel vehicles. They include the:

- Qualified fuel cell motor vehicle credit,
- Advanced lean burn technology motor vehicle credit,
- Qualified hybrid motor vehicle credit, and
- Qualified alternative fuel motor vehicle credit.

These four credits have certain common aspects. First, the taxpayer must be the original user of the vehicle. Second, the vehicle must be acquired for use or lease by the taxpayer. It cannot be purchased for resale. Finally, the vehicle must be made by a manufacturer.

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Any eligible credits may be carried back 3 years and forward 20 years. However, no credit may be carried back to a year before the credit first became available. The vehicle's basis is reduced by any credit claimed and the taxpayer may not take a double deduction if the vehicle qualifies for any other credit or deduction. The IRS is expected to issue rules regarding the recapture of the credits. It is already known that the credit received for a leased vehicle is recaptured if the lease period is less than the economic life of the vehicle. Unfortunately, the term "economic life" has not been defined.

The credits are available for qualified vehicles placed in service after December 31, 2005.

Qualified Fuel Cell Motor Vehicle. This credit is only available for vehicles which are powered by energy created by combining oxygen and hydrogen. The credit ranges from $8,000 to $40,000 depending on the weight of the vehicle.

Vehicles classified as "passenger automobiles" or "light trucks" and which meet fuel efficiency standards can increase their credit between $1,000 and $4,000. The increased credit is based on fuel efficiency tables.

Advanced Lean-Burn Technology Motor Vehicles. In addition to meeting the three requirements common to all of the new credits, a lean-burn vehicle must meet three additional requirements:

1. It must be designed to use more air than is necessary for complete combustion of the fuel,
2. It must incorporate direct injection, and
3. It must achieve at least 125% of the 2002 model year city fuel economy.

The amount of the credit ranges from $400 to $2,400 based on the fuel savings percentage. The credit may be increased between $250 and $1,000 based on lifetime fuel savings.

This credit is subject to a phaseout. The phaseout is based on the number of vehicles a manufacturer produces. The phaseout begins once 60,000 qualified vehicles have been produced by the manufacturer.

Qualified Hybrid Motor Vehicle Credit. In addition to the three standard requirements, a qualified vehicle must be powered by energy stored onboard. The vehicle must be powered by both an internal combustion engine and a rechargeable energy system. The vehicle must be certified before it is eligible for the credit and must also meet certain maximum available power standards.

Congress specified vehicles weighing 8,500 lbs. or more do not qualify for the credit. This eliminates many SUVs from qualifying.

The amount of credit available is the same as available to lean-burn technology vehicles. ETIA also places a 60,000-vehicle minimum on manufacturers before a credit phaseout begins.

There are a number of qualifying current hybrids with more expected to be released over the next two years. Current and future hybrids include:

Currently Approved	Expected to Be Released and Approved
Honda Civic Hybrid 2003–2005*	Mercury Mariner 2006
Honda Insight Hybrid 2000–2005*	Toyota Camry 2006
Honda Accord Hybrid 2005*	Saturn VUE 2006
Toyota Prius Hybrid 2001–2005*	Nissan Altima 2006
Ford Escape Hybrid 2005*	Mercedes S-Class Hybrid 2006
Chevy Silverado Hybrid 2004 (fleet)	Lexus GS 450h Hybrid Sedan
GMC Sierra Hybrid 2004 (fleet)	Chevy Malibu Hybrid 2007
Lexus RX 400h 2006* (Available 2005)	Chevy Equinox Hybrid 2007
Toyota Highlander Hybrid 2006*	Chevy Tahoe Hybrid 2007
	GMC Yukon Hybrid 2007

*As of Aug 23, 2005 certified for the clean fuel deduction.

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Clean-Fuel Vehicle Refueling Property

Assuming the ETIA meets it objectives, many more alternative fuel vehicles will be developed and sold. Consequently, Congress included provisions to encourage the establishment of clean-fuel refueling stations. These expenses are currently deductible under §179A. The current expensing limit deduction is $100,000 for the property at each location owned by the taxpayer. This deduction expires December 31, 2005.

Under the new law, taxpayers may claim a 30% credit for the cost of installing clean-fuel refueling property at a taxpayer's business or installed at the taxpayer's principal residence. For retail clean-fuel refueling property, the credit may not exceed $30,000. For clean-fuel refueling property installed at the taxpayer's residence, the credit may not exceed $1,000.

Under this provision, clean fuels are any fuel at least 85% of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, and hydrogen and any mixture of diesel fuel and biodiesel containing 20% biodiesel. The property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged.

The taxpayer's basis in the property is reduced by the credit and no deduction under §179A is allowed for property on which the credit is claimed. If the property is located on property owned or used by a tax-exempt taxpayer, the taxpayer that installs the property may claim the credit.

The portion of the credit attributable to property subject to an allowance for depreciation is treated as a portion of the general business credit. The remainder of the credit is allowable to the extent of the excess of the regular tax (reduced by certain other credits) over the AMT for the taxable year.

The provision is effective for property placed in service after December 31, 2005, and before January 1, 2010. The credit relating to hydrogen terminates for property placed in service after December 31, 2014.

Biodiesel Credits

The biodiesel fuels income tax credit and the biodiesel mixture excise tax credit is extended through December 31, 2008.

Small Agri-Biodiesel Producer Credit

The small agri-biodiesel producer credit mirrors the small ethanol producer credit. The credit is 10¢ per gallon for the first 15 million gallons of agri-biodiesel production for each eligible producer. An eligible producer is defined as a producer who does not have production capacity exceeding 60 million gallons.

A co-op may pass the credit through to its members in the same manner as the ethanol credit pass-through.

Renewable Diesel

Renewable diesel is treated the same as biodiesel for the excise tax credit and payment purposes except that:

1. The biodiesel mixture credit and the biodiesel credit are determined using a $1 per gallon rate rather than 50¢ per gallon for renewable diesel, and
2. The agri-biodiesel mixture credit and the small producer agri-biodiesel producer credit do not apply to renewable diesel. Therefore, the renewable diesel income tax credit is similar to the biodiesel credit.

Renewable diesel is defined as diesel fuel produced from biomass using a thermal depolymerization process. The process produces renewable diesel from such materials as turkey offal.

The renewable diesel credit applies to fuel sold or used between December 31, 2005, and December 31, 2008.

Excise Tax Credit for Alternative Fuels

The SAFE Transportation Equity Act of 2005 provides for an excise tax credit for alternative fuels. The credit varies by the type of fuel.

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Larger Producers Eligible for Small Ethanol Producer Credit

ETIA increases small producer ethanol credit to producers who have up to 60 million gallons of production capacity.

Change in Refund for Diesel Fuel Used on Farms

The Highway Bill changes the manner of claiming the federal excise tax on undyed diesel fuel used in farming. In the past, some farmers were able to purchase undyed diesel fuel without the fuel distributor charging the federal excise tax. The fuel distributor would then file for a refund of the federal excise tax.

> **Note.** Typically, farmers purchase dyed diesel fuel and are not charged the excise tax by the fuel distributor.

Under the new law, on or after October 1, 2005, if the farmer purchases undyed diesel fuel, the distributor will charge the excise tax. If the fuel is used for off-highway farming purposes, the farmer must file Form 4136 to refund the 24.4¢ per gallon federal excise tax.

There is no change in the way dyed diesel fuel is treated. It is still sold to the farmer for qualified farming purposes excise tax free.

Federal Excise Tax Exemption for Crop Dusters

Under the old law, when fuel was used by a crop duster, he was required to get a waiver from the farmers for whom he was spraying in order to file a refund claim. The farmer was considered the ultimate purchaser of the fuel. Under the new law, the crop duster is considered the ultimate purchaser and is eligible to file the claim for the excise tax refund.

Credit for Homeowner Energy Efficiency Improvements

The bill allows a 10% credit for the purchase of qualified energy efficiency improvements to existing homes. The maximum lifetime credit for a building is $500. Qualified improvements include energy efficient building envelope components meeting specific requirements. To qualify, these components must be:

- Installed in or on a dwelling located in the United States,
- Owned and used by the taxpayer as the taxpayer's principal residence, and
- Reasonably expected to remain in use for at least five years.

The original use of the component must commence with the taxpayer. Building envelope components include:

- Insulation materials or systems specifically designed to reduce heat loss or gain for a dwelling,
- Exterior windows (including skylights) and doors, and
- Metal roofs with appropriate pigmented coatings specifically and primarily designed to reduce heat loss or gain for a dwelling.

The taxpayer's basis in the property is reduced by the amount of the credit.

A credit is also allowed for the purchase of energy efficient property. There are limits for various types of property. These limits are as follows:

1. $50 for each advanced main air circulating fan
2. $150 for each qualified hot water boiler or natural gas, propane, or oil furnace
3. $200 for window components
4. $300 for each item of qualified energy efficiency building property

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An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the year and which has an annual electricity use of no more than 2% of the total annual energy use of the furnace as determined in the standard Department of Energy test procedures.

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

Qualified energy efficiency building property includes the following:

1. An electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedures
2. An electric heat pump meeting certain a certain seasonal efficiency ratio
3. A geothermal heat pump meeting certain requirements
4. A central air conditioner meeting certain requirements
5. A natural gas, propane, or oil water heater which has an energy factor of at least 0.80

The residence must be located in the United States and, in the case of a new residence, not be acquired from a contractor eligible for the production of a new energy efficient home credit. Vacation homes and rental units do not qualify for the credit.

The credit applies to property placed in service after December 31, 2005, and prior to January 1, 2008.

Energy Efficient New Homes

This credit is provided to an eligible **contractor** for the construction of an energy efficient new home or the producer of a new manufactured home. An eligible contractor is a person who constructs a new energy-efficient home or a manufacturer who produces a qualified new energy-efficient manufactured home. To qualify as an energy-efficient home, the home must be:

1. A dwelling located in the United States,
2. Substantially completed after the date of enactment, and
3. Certified to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30% or 50% reduction in energy use. For the 30% standard, one-third of the 30% savings must come from the building envelope; for the 50% standard, one-fifth of the 50% savings must come from the building envelope.

The credit equals $2,000 in the case of a new home or manufactured home that meets the 50% standard. The credit is $1,000 for a manufactured home that meets the 30% standard.

The building envelope is considered to be:

- Insulation materials or systems specifically and primarily designed to reduce heat loss or gain,
- Exterior windows, including skylights,
- Doors, and
- Any duct sealing and infiltration reduction measures.

The credit is part of the general business credit. No credits attributable to energy-efficient homes can be carried back to any taxable year ending on or before the effective date of the credit. The credit is effective for construction which is substantially completed after December 31, 2005, and which are purchased after December 31, 2005, and prior to January 1, 2008.

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Energy-Efficient Commercial Buildings Deduction

This provision provides a deduction for property placed in service after December 31, 2005, that qualifies as energy-efficient commercial building property expenditures. These expenditures are defined as depreciable property which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America. This property can be a part of the:

- Interior lighting systems;
- Heating, cooling, ventilation, and hot water systems; and
- The building envelope.

The property must be certified as being installed as part of a plan designed to reduce the total annual energy and power cost for the above items by 50% or more in comparison to a reference building. The deduction is limited to $1.80 per square foot of the property for which the property is placed in service.

> **Example 9.** Tony Landlord decides to install a new natural gas heating system in his 80,000-square-foot office building. Tony can deduct up to $144,000 of the expense as long as he is replacing a natural gas heating system and the total building energy costs are reduced by 50% or more.

If the qualified expenditures are made to a building by a public entity, such as a public school, the deduction may be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is taken, the basis of the property must be reduced by the amount of the deduction. If the property does not meet the 50% energy savings requirement, a partial deduction is allowed for each separate system on the property that is certified as meeting the savings target. The separate systems are the same three mentioned above. The allowable deduction is $0.60 per square foot for each system.

> **Example 10.** Use the same facts as **Example 10**, except the energy costs relating to the heating are reduced by 50%, but the entire building energy costs are not reduced by 50% or more. Tony is only allowed a maximum deduction of $48,000 or the cost of the heating system.

> **Observation.** Unlike the credit for energy-efficient residences, it appears the building owner is entitled to the credit.

This provision is effective for property placed in service after December 31, 2005, and prior to January 1, 2008.

Energy-Efficient Appliances

The bill contains a provision which provides a credit for energy-efficient dishwashers, clothes washers, and refrigerators. These appliances must meet certain requirements to be eligible for the nonrefundable credit.

The credit goes to the manufacturer of the appliance, not the consumer. The indirect benefit to the consumer is the lower energy bills. The credit is available for qualifying appliances produced after December 31, 2005.

Business Solar Investment Tax Credit

The current 10% business solar investment tax credit is increased to 30% for solar energy property, hybrid solar lighting systems, and qualified fuel cell property. Hybrid solar lighting systems consist of equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure. Property used in generating solar energy to heat a swimming pool is not eligible solar property.

The 30% credit and the fiber-optic provision are effective for periods after December 31, 2005, and before January 1, 2008. The provision relating to swimming pools is effective after December 31, 2005.

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Personal Residence Solar and Fuel Cell Credit

The act provides a nonrefundable personal credit of 30% of the cost of eligible solar water heaters, solar electrical equipment, and fuel cell plants. The maximum credit is $2,000 per tax year for **each** category of solar equipment. There is an additional credit of $500 for each half kilowatt of fuel cell capacity of fuel plants installed each year. Cooperative and condominium owners may split the cost for the equipment installed. Unused credits may be carried forward.

If the taxpayer receives state or local financial incentives for the purchase of the above equipment, only excess expenditures qualify for the credit. The states furnishing financial incentives are tracked at **www.dsireusa.org.** The credit does not apply for property used to heat swimming pools and hot tubs.

The credit only applies for eligible property placed in service in 2005 and 2006.

RENEWABLE AND CLEAN ENERGY INCENTIVES

The act extends the renewable electricity production credit for certain qualified facilities. It also authorizes the issuance of $800 million in tax-credit bonds before December 31, 2007, to support renewable investment by municipal power authorities, rural cooperatives, and others.

CLEAN COAL

The act provides three credits for investments in clean coal facilities. It also allows power plants to amortize the cost of air pollution facilities over 84 months. In addition, the act allows unused credits for fuel produced from nonconventional sources to be carried back one year and forward up to 20 years.

ELECTRICITY RELIABILITY

The act provides incentives related to electricity production. These incentives include credits, shorter depreciation recovery periods, and a longer NOL carryback period. Ten different energy resources are included when determining what property qualifies for the deductions and credits. ETIA added hydroelectric production and "Indian" coal to the list of qualifying resources.

OIL AND GAS PRODUCTION AND ENHANCED REFINING

The incentives provided in the act include shorter recovery periods, a 50% expensing provision for certain refinery investments, and percentage depletion for some small refiners. There are also provisions related to a safe harbor exemption for tax-exempt bond arbitrage, and the deductibility of costs incurred to comply with EPA low sulfur diesel regulations.

OTHER PROVISIONS

§197 Intangible Amortization Recapture

ETIA includes one provision which is unrelated to energy. This provision deals with the recapture of amortization on intangibles. The bill provides that upon the sale or disposition of more than one intangible asset, the seller must recapture amortization as if all of the §197 intangibles were a single asset. Therefore, any gain on the sale is recaptured as ordinary income to the extent of ordinary depreciation deductions previously claimed on the §197 property.

The above multiple sale provision does not apply to any §197 intangible if the adjusted basis exceeds the FMV at the time of sale.

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Example 11. In Year 1, Kelly acquires two §197 intangible assets for $45. One of the assets has a cost basis of $15 and the other $30. Since the assets are amortized over 15 years, Kelly is entitled to a deduction of $3 per year ($45 ÷ 15).

In Year 6, the basis of the first item is $10 and the basis of the other is $20. Kelly sells the assets in an aggregate sale for $45, resulting in a gain of $15 ($45 – $10 – $20). Under current law, the character of the gain depends on the recapture amount, which depends on the relevant sale price of the individual assets. The first item has a recapture potential of $5 and the second asset has a recapture potential of $10. Therefore, if Kelly allocated $15 of the sale price to the first asset and $30 to the other asset, she recognizes gains of $5 and $10 respectively. Because these amounts match the recapture potential of the individual assets, all of the gain is treated as ordinary income.

However, if Kelly allocates $25 to the first asset and $20 to the other, the full $15 gain is recognized against the first asset, but only $5 is treated as ordinary income. The remaining gain of $10 is treated as a capital gain. No gain or loss is recognized for the sale of the second asset.

Under the new law, Kelly reports a $45 sale with a $30 basis, and the entire $15 gain is an ordinary gain.

The new law is effective for dispositions of property after the date of enactment.

Extension of Daylight Savings Time

The ETIA has one provision which does not provide financial incentives. This provision extends daylight savings time (DST) for an additional month. DST will begin three weeks earlier or on the second Sunday in March. It will end one week later on the first Sunday in November.

The provision is not effective until 2007, which gives the government time to study the provision to determine if it will create an energy savings.

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