Chapter 14: New Legislation

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

TAX INCREASE PREVENTION AND RECONCILIATION ACT

OVERVIEW

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) was enacted on May 17, 2006.[1] TIPRA, which contains approximately $90 billion in tax cuts and $20 billion in revenue raisers, affects almost every type of taxpayer with provisions for individuals, pass-through entities, businesses, corporations, tax-exempt entities, and government agencies. This chapter does not cover all provisions of the act.

Caution. The effective dates of TIPRA provisions vary. Some provisions are retroactive, while others do not become effective until 2011.

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1. Although the provisions of TIPRA are effective in 2006, the act has a 2005 designation because it was originally presented for debate in that year.

EXTENSION AND MODIFICATION OF EXISTING LAW

The first part of TIPRA extends provisions of the tax code that were due to sunset. However, some of the more controversial extender provisions in the original bill were removed. A "trailer" bill is expected to follow and may be incorporated into the pension bill that is still being debated as this chapter was being written.

Increased Expensing for Small Business

Many of the provisions of IRC §179 were due to expire at the end of 2007. TIPRA extends these expiration dates to the end of 2009. Extensions apply to the following provisions:

- $100,000 deduction limitation[2]
- $400,000 phaseout threshold[3]
- Cost-of-living adjustment allowances for the deduction limitation and phase-out threshold[4]
- Option to revoke a §179 election[5]
- Qualification of computer software as §179 property[6]

Inflation adjustments for 2006 raise the §179 deduction limitation to **$108,000** and the phase-out threshold to **$430,000.**

Caution. The §179 expense deduction is not available to estates, trusts, and certain noncorporate lessors.

Capital Gains and Dividend Rates

The reduced tax rates on capital gains and dividends, enacted in 2003 under the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), were scheduled to expire at the end of 2008. The elimination of the 5-year holding period required to qualify certain assets for capital gain treatment was also due to sunset. TIPRA extends the expiration dates for the reduced rates and the elimination of the 5-year holding period through the end of 2010.

Lower capital gain tax rates were also extended for regulated investment companies (RIC) and real estate investment trusts (REIT). The zero tax rate on capital gains for taxpayers in the 5% and 15% tax brackets remains in effect for the 2008 to 2010 tax years.

However, the bill did not solve the potential AMT problem associated with capital gain income. Currently, 50% of gain on small business stock, as defined in IRC §1202, is excluded from taxation. However, 7% of the excluded gain from the sale of a small business stock is treated as a preference item for AMT. This provision remains in effect for tax years 2008 through 2010.

Observation. Beginning in 2011, the top capital gain rate is scheduled to increase from 15% to 20%, which is a 33% increase. For taxpayers in the 35% bracket, the loss of the 15% rate increases the tax on dividends and net capital gains by 130%.

After the 15% tax rate for capital gains expires at the end of 2010, the holding period rules resume that apply to property held for at least five years. Taxpayers in the 10% and 15% brackets will be taxed at a 10% rate on gains from property held over five years. Gains from the sale of 5-year property will be capped at a rate of 20% for taxpayers with a regular tax rate greater than 15%.

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2. IRC §179(b)(1)
3. IRC §179(b)(2)
4. IRC §179(b)(5)
5. IRC §179(c)(2)
6. IRC §179(d)(1)(A(ii)

OTHER PROVISIONS

Taxation of Superfunds

TIPRA provides that certain settlement funds resulting from claims filed under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), commonly referred to as "superfunds," are not taxable. These funds are considered owned by the United States. The interest income from other types of funds or escrow accounts is taxable at the trust rate.

SPECIAL INTEREST GROUP PROVISONS

Capital Gain Treatment for Certain Self-Created Musical Works

IRC §1221 excludes inventory, copyrights, musical or artistic compositions, literature, letters, and memorandums from the definition of a capital asset. TIPRA redefines musical compositions and copyrights held for musical rights as capital assets if sold or exchanged by the taxpayer in tax years beginning after May 17, 2006, and before January 1, 2011.

Sale proceeds from these assets previously were taxed at ordinary income rates. This provision creates the potential for large tax savings for composers selling their entire catalogue of songs, since a catalogue sale can generate proceeds ranging from $300,000 to $3 million. Royalties and advancements continue to be taxed as ordinary income.

> **Note.** The executive director of the Nashville Songwriters Association International is quoted as saying he made more than 500 trips to Washington in an effort to change this law.

Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights

Under the new law, taxpayers may elect to amortize the cost of creating or acquiring musical property over five years. To qualify, the property must be created or acquired after December 31, 2005, and before January 1, 2011. This provision only benefits taxpayers who acquire musical property or employ musical creators since sole proprietors may already deduct the costs of creating a music composition.

Property Held in a Permanent University Fund

Section 648 of the Deficit Reduction Act of 1984 provides that property held in a Permanent University Fund of the University of Texas and Texas A & M University is not treated as an investment of bond proceeds for Code arbitrage restrictions. The new law allows bonds issued after the date of enactment and before August 31, 2009, to be included if annual distributions do not exceed 7% of the average fair market value of the assets held in the fund.

Qualified Veterans' Mortgage Bonds

To apply for qualified veterans' mortgage bond financing, veterans must have served their country before 1977 . The new law reduces the elapsed waiting period to apply for the financing from 30 years to 25 years. This revision is effective for bonds issued on or after May 17, 2006, and involves bonds issued by Alaska, Oregon, and Wisconsin. There is no change in the law regarding bonds issued by California and Texas. The new law also limits the number of loans which may be issued. This volume limit is eliminated after 2010.

REITs and RICs

The treatment of real estate investment trusts (REITs) is modified by some provisions of TIPRA in respect to the Foreign Investment in Real Property Tax Act (FIRPTA) and distributions attributable to FIRPTA gains. The lower tax rates on capital gains and dividends passed through by a REIT continue to apply.

The modifications of FIRPTA also apply to regulated investment companies (RICs). However, a RIC either must be a U.S. holding company or would be considered a U.S. holding company if the regularly traded stock and domestically controlled entity exceptions did not apply. Distributions to a foreign investor by a RIC are not treated as FIRPTA income unless the RIC is a U.S. real property holding company.

Observation. There are other provisions relating to the FIRPTA rules and their application to REITs and RICs.

ALTERNATIVE MINIMUM TAX RELIEF

The alternative minimum tax (AMT), which became effective in 1969, intended to create tax liability for very-high-income taxpayers who were using various loopholes and code provisions to escape tax liability. Initially lower-income taxpayers generally were exempt from AMT because the income threshold ceilings were high. However, these thresholds were not indexed annually for inflation. Consequently, it is estimated that 21 million taxpayers could be liable for AMT in 2006.

Exemption Amount

Many legislators favor a complete repeal of AMT, but Congress estimates this would cost $611 billion over a 10-year period. Instead, TIPRA attempts to resolve the inflation problem by increasing the 2006 exemption for each filing status to the following amounts:

- Married filing jointly: $62,550
- Single: $42,500
- Married filing separately: $31,275

The AMT exemption for corporations remains at $40,000 and the estate and trust exemption amount remains at $22,500.

This extension applies only for 2006. Although the 2006 exemption amount has increased, the threshold for calculating the phase-out remains at a 25% reduction for each dollar of AMT income over $150,000 for taxpayers filing married filing jointly, $112,500 for unmarried taxpayers, and $75,000 for married taxpayers filing separately.

Note. Unless Congress makes further changes to AMT, the AMT exemptions will return to $45,000 for married filing jointly taxpayers, $33,750 for unmarried taxpayers, and $22,500 for married filing separate taxpayers in 2007.

Credits Applying to AMT

TIPRA also extends the application of some personal nonrefundable tax credits to the AMT. The following credits can be applied in full against AMT:

- Dependent care credit
- Credit for the elderly and disabled
- Adoption credit
- Child tax credit
- Credit for interest on certain home mortgages
- Hope scholarship credit
- Lifetime learning credit
- Retirement savers credit

This provision does not apply to the nonrefundable portion of the alternative motor vehicle credit and the credit for alternative motor vehicle refueling property.

> **Note.** A discussion on AMT is included in Chapter 2, "Individual Taxpayer Problems," Problem 2.

Gain from Sales of IRC §1202 Small Business Stock

Up to 50% of the gain from the sale of small business stock can be excluded from regular tax by noncorporate investors.[7] To qualify, the stock must have been issued by a C corporation and at least 80% of the assets must be used in the active conduct of a trade or business. The stock does not qualify if the total corporate asset value exceeds $50 million. The corporation must have issued the stock after August 10, 1993.

Through 2010, 7% of the excluded gain is treated as a tax preference for AMT purposes. After December 31, 2010, 42% of the excluded gain will be treated as an AMT preference item. If the stock qualifies as 5-year property, 28% will qualify as a tax preference.

ROTH IRAs

Under prior law, a taxpayer could not convert a traditional IRA into a Roth IRA if his adjusted gross income (AGI) was $100,000 or higher. The new law removes this limitation and allows taxpayers to roll their traditional and nondeductible IRA accounts into a Roth IRA regardless of the size of their income. TIPRA also allows married couples filing separate returns to convert their traditional IRAs into Roth IRAs.

The TIPRA Roth IRA conversion provisions are effective for tax years beginning **after December 31, 2009.** Taxpayers who are currently considering a conversion from a traditional IRA to a Roth IRA may be advised to wait until 2010. Then, taxpayers will be allowed a 2-year period to recognize income from the conversion. The income must be spread ratably over 2011 and 2012 unless the taxpayer elects to include all of the income in 2010. All income must be recognized in the year of conversion for years after 2010.

Example 1. Megan converts her $200,000 traditional IRA to a Roth IRA in 2010. She reports $100,000 of conversion income in 2011 and $100,000 in 2012, unless she elects to report the entire $200,000 in 2010.

A taxpayer who receives a **postconversion Roth IRA distribution before 2012** is subject to an accelerated income inclusion provision. If this occurs, the amount included in income in the year of distribution is increased by the distribution amount. The amount included in income in 2012 (or 2011 and 2012 for a 2010 postconversion distribution) is the lesser of:

1. One-half of the amount includible in income as a result of the conversion, or
2. The remaining portion of the includible amount that was not previously taxed.

Example 2. Use the same facts as in **Example 1,** except Megan takes a postconversion distribution of $25,000 in 2010. Since this is not a qualified distribution, she must include the $25,000 in gross income in 2010. She then includes $100,000 of the conversion in income in 2011 and the remaining $75,000 in 2012.

> **Observation.** Since high-income taxpayers cannot make contributions to Roth IRAs, these taxpayers may wish to consider making nondeductible IRA contributions now, and later roll their traditional IRAs into a Roth IRA in 2010. If they have a plan available, high-income taxpayers may also consider making contributions to the new designated Roth 401(k)/403(b) plans, which have no income eligibility restrictions. A complete discussion of Roth 401(k) plans is found in Chapter 6, "Retirement Issues."

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7. IRC §1202(a)(1)

Example 3. Reggie and Sherri are both age 40, participants in employer-provided plans, married, and earn too much to deduct traditional IRA contributions. However, they are allowed to make nondeductible contributions. If they make the maximum nondeductible contributions allowed between 2006 and 2010, they each can contribute $4,000 for 2006 and 2007 and $5,000 in 2008, 2009, and 2010. This allows them to accumulate $46,000 of contributions in their combined IRA accounts.

Their combined accounts grew to $60,000 with earnings by 2010. In 2010, they opt to convert the nondeductible IRA to a Roth IRA. At the time of conversion, they may either elect to report the earnings of $14,000 ($60,000 – $46,000) in income in 2010, or choose to spread out the liability by reporting $7,000 in 2011 and $7,000 in 2012. They may continue to make nondeductible contributions each year and then roll their contributions into a Roth IRA.

Congress anticipates this provision will be a big revenue raiser. Considering the large amounts of money taxpayers have accumulated in traditional IRA plans, this conversion election could generate substantial revenue. There is no sunset date for this provision.

Note. Taxpayers should watch for additional legislation. Currently the tax rate reductions of TIPRA are scheduled to sunset after 2010. If this happens, a taxpayer may be better off reporting the entire conversion amount as income in 2010.

Caution. Before converting from a traditional to a Roth IRA, taxpayers should be sure they can pay the resulting tax without using any of the converted funds, since any part of a distribution that is not rolled over may be subject to a 10% early distribution penalty. Taxpayers should also be aware of any state laws that may affect the conversion. While a traditional IRA account may be protected from creditors, a Roth IRA account may not be protected.

INCOME FROM WORKING ABROAD

Effective for tax years beginning after December 31, 2005, U.S. citizens working abroad can exclude part of the compensation they earned while abroad. However, the earnings and housing allowances they may exclude when computing adjusted gross income must be taken into account when determining the tax rate for their nonexcludible U.S. source income. The foreign income exclusion is reported on Form 2555, *Foreign Earned Income.*

TIPRA accelerated the indexing of the foreign income exclusion. The 2006 foreign earned income exclusion is $82,400. The maximum exclusion for qualified housing costs increased to $11,536. This is generated from a formula based on 30% of the compensation exclusion amount, minus 16% of the compensation exclusion, and taking into account the number of days of foreign residence or presence. The 30% amount is adjusted annually based on geographical differences in housing costs relative to U.S. housing costs.

To qualify for the exclusion, a taxpayer must be a bona-fide resident of the foreign country or meet a physical presence test. To meet the bona-fide resident test, a taxpayer must be in the foreign country for an uninterrupted period of time from January 1 through December 31.[8] To meet the physical presence test, a taxpayer must be present in the foreign country at least 330 days during a period of 12 consecutive months.[9]

While qualified taxpayers may exclude part of their earnings and housing allowance from taxable income, other types of nonexcludible income, such as dividends and interest, are taxable. The tax rate is based on a "stacking rule," which means the excludible and nonexcludible incomes are combined to determine the marginal tax rate on the taxpayer's total income. This rate then is applied to only the taxable (nonexcludible) income.

8. IRC §911(d)(1)(A)

9. IRC §911(d)(1)(B)

Example 4. Craig works in China for the entire year and earns $70,000 of compensation plus a housing allowance of $8,000. Craig also has $15,000 of dividend and interest income from U.S. sources.

Craig is taxed on only his nonexcludible interest and dividend income of $15,000. However, his tax rate is based on $93,000 of income ($70,000 + $8,000 + $15,000).

LOANS TO QUALIFIED CARE FACILITIES

Taxpayers often begin evaluating their retirement living options as they approach the end of their working careers. Since today's families are frequently scattered, many retirees have no close relatives. Aging parents who have family nearby often have employed adult children (and their spouses) who are seldom available to assist the aging parent continue to live in his own home.

Many retirees now are opting to live in continuing care retirement communities (CCRC). These new facilities have many amenities that are attractive to seniors who may not currently need medical care or assisted living, but want to plan for the future. By moving into a CCRC facility when they are active and healthy, seniors can continue to live an independent lifestyle. As their medical and physical needs progress, they can transfer to a different section of the facility where they can receive advanced care and services.

These facilities offer numerous plans. Most require a deposit, which can range from $25 to over $300,000. Some deposits are refundable, but many are not. The IRS considers certain **refundable** deposits as loans to a facility, and hence the deposit is subjected to imputed interest rules.

IRC §7872 requires interest be imputed for below-market interest loans unless certain requirements are met. The exceptions include loans of $10,000 or less, loans to qualified continuing care facilities,[10] and others.

TIPRA changed the imputed interest rules for some types of loans to qualified care facilities. Previously the cap was $163,000 on loans excepted from the imputed interest rules, but this cap is removed for years after 2005 and before 2011. TIPRA also lowered the age of the lender or lender's spouse **from 65 to 62 or older** before the end of the year.

TIPRA also modified the definition of "qualified care facility" and "qualified continuing care facility." To be qualified for the exception from imputed interest rules, a continuing care facility must include an assisted living facility and/or a nursing facility, in addition to the independent living unit.

In order to qualify for this TIPRA provision, the following additional qualifications must be met:

- The taxpayer (or spouse) must be age 62 before the end of the year,
- The loan must be:
    - Less than the annual adjusted threshold amount (this requirement is moot for tax years 2006–2010, since TIPRA eliminated the cap for these years),
    - Entered into as a result of a continuing care contract, and
    - Lent to a qualified continuing care facility.

To qualify, a contract must be made between the taxpayer and a qualified facility. The contract must provide for the following:

- The taxpayer can use the facility for the duration of the taxpayer's or his spouse's lifetime.
- The taxpayer is provided with meals and personal care options in an independent living unit without long-term nursing care.
- The taxpayer may move into a long-term care facility when necessary.

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10. IRC §7872(g)

A facility is qualified if it has one or more facilities designed to provide the above services and substantially all of the residents are covered under similar contracts. Substantially all of the facilities must be owned by the borrower and must not be considered nursing homes.

TIPRA made some additional changes to the law. These include:

- Taxpayers no longer need to transfer from the independent living portion of the facility to the long-term care portion.
- A facility may now charge an additional fee for providing long-term care.
- A borrower no longer needs to own substantially all of the facilities.
- There is no cap on the amount of the loan.

Caution. These TIPRA provisions sunset on December 31, 2010.

Example 5. Don and Carol, who are both age 63, have been considering the payment of a substantial **refundable** "entrance fee" (deposit) in order to gain admittance to a posh Arizona CCRC. The minimum "entrance fee" for 2006 for an independent living unit in the **qualified** Arizona CCRC is $400,000. They paid the $400,000 "entrance fee" in July 2006. They continue to live in their Illinois residence in 2006.

Under prior law, the 2006 $400,000 "entrance fee" paid by Don and Carol would have been subject to the imputed interest rules under IRC §7872. However, under TIPRA, the imputed interest rules no longer apply to this "entrance fee" for the 2006 through 2010 tax years. This provision will save Don and Carol substantial income taxes during those five tax years.

KIDDIE TAX

Many parents reduce their income tax liability by shifting income to their minor children to take advantage of their children's lower tax rates. Congress implemented the "kiddie tax" to circumvent this practice by taxing the unearned income of children under age 14 at their parent's tax rate. TIPRA **retroactively** extends this kiddie tax to children **under age 18** as of December 31, 2006 whose 2006 unearned income exceeds $1,700.

Example 6. Karla, who is age 17 at the end of 2006, has her own brokerage account with $150,000 of funds invested in corporate bonds. Karla's 2006 interest income is $8,000. She has no earned income in 2006.

Due to the TIPRA provisions, Karla's 2006 total tax liability is $3,055, computed as follows:

AGI (interest income)	$8,000
Less: standard deduction	(850)
Taxable income	$7,150

Tax on the first $850 of interest due to standard deduction	$ 0
Tax on the next $850 of interest using Karla's tax rate ($850 × 10%)	850
Tax on the $6,300 balance of interest using parent's top tax rate ($6,300 × 35%)	2,205
Karla's total 2006 total tax on her $8,000 of interest income	**$3,055**

Under prior law, Karla's total 2006 tax would have been only $715 ($8,000 – $850 standard deduction = $7,150 × 10% = $715).

Due to the TIPRA provision, Karla's 2006 tax liability is **$2,340 greater** than under prior law. This example shows that this TIPRA provision is a significant revenue raiser.

> **Note.** This provision exempts income a child receives from certain qualified disability trusts because it is treated as earned income. It also exempts income of a married child who files a joint tax return with her spouse. An actual joint return must be filed; simply being eligible to file jointly does not exclude this income from the parents' tax rate. However, the income is exempt if neither parent is alive at the close of the tax year.

Parents who planned to sell stocks or bonds in a child's portfolio because the child attained the age of 14 in 2006 must now wait or face higher taxes. Under the old law, if the stock was sold in 2008, any gains may have escaped tax since the child would presumably be in a tax bracket low enough to be exempt from the capital gains tax. However, if the child is under age 18 in 2008, the gain is subject to tax at the parent's rate, which is presumably high enough to trigger a capital gains tax.

TAX-EXEMPT ENTITIES INVOLVED IN TAX SHELTERS

Tax exempt entities that invest in tax shelters are subject to new rules under TIPRA, effective for tax years ending after May 17, 2006. This provision imposes a tax on the manager of a tax-exempt entity for approving any action that causes an entity to engage in a prohibited transaction. The tax imposed is $20,000 per action.

An officer, director, or trustee of the organization is considered the manager of the entity. Tax-exempt entities include such accounts as IRAs, other retirement accounts, health savings accounts, and qualified tuition plan accounts. The act lists several factors which qualify the investment as a tax shelter.

Exempt entities are also subject to an excise tax. The excise tax is the lesser of 75% of the income attributable to the tax shelter or 100% of the entity's income.

OFFERS IN COMPROMISE

Effective July 16, 2006, taxpayers who submit an offer in compromise which includes five or fewer payments must include a down payment of 20% when they file Form 656, *Offer in Compromise*. This payment is nonrefundable if the offer is rejected. If a user fee is imposed, it must be submitted with the offer and is applied to the taxpayer's outstanding tax liability.

Periodic payment offers require taxpayers to make payments according to the payment schedule they requested. If the IRS fails to respond to an offer within two years, the offer is deemed accepted. If an offer is made without an accompanying payment, it is returned without being processed.

This may concern some taxpayers. For example, a taxpayer who proposes an offer to make payments over a 12-month period may have made all the proposed payments before the IRS approves or rejects the offer. If the offer is rejected, the payments are credited toward the entire liability.

Example 7. David has an outstanding federal tax liability of $340,000. He submits an offer in compromise for $100,000. If the offer is sent after July 16, 2006, he must include a payment of $20,000 with the offer. If the offer is rejected, the $20,000 is applied to the $340,000 liability and he now owes $320,000, plus any additional penalties and interest.

In addition, David must send a $150 user fee with the offer. If the offer is accepted, the user fee is applied to his outstanding liability. If the offer is rejected, it is also applied to the balance.

> **Note.** This is an attempt by Congress to limit the abuse of the offer-in-compromise provisions. Some taxpayers were only making an offer to delay payment of their total tax liability.

TAX-EXEMPT BOND INTEREST

Payors of tax-exempt bond interest are not currently required to report this amount on Form 1099-INT.[11] Under the new law, effective for interest paid after December 31, 2005, payors must report any tax-exempt interest paid of $10 or more.

> **Observation.** Taxpayers must use the amount of tax-exempt interest in several tax calculations. It is needed for calculating the taxable amount of social security earnings and state income tax. Private activity bond interest is also a preference item necessary for computing AMT.

PRIVATE ACTIVITY SMALL ISSUE BOND LIMIT

Under prior law, interest on certain private activity small issue bonds was tax exempt to the recipient if at least 95% of the bond proceeds were used to finance private business manufacturing facilities or the acquisition of certain agricultural land or equipment. The bonds could not have an aggregate authorized face amount in excess of $1 million. The issuer could elect an aggregate amount up to $10 million, but was required to include certain capital expenditures in the computation of the aggregate amount.

TIPRA excludes the first $10,000 of qualified bonds, which raises the limit to $20,000. The TIPRA provision is effective for bonds issued after December 31, 2006.

IRC §199 QUALIFIED PRODUCTION ACTIVITIES DEDUCTION

> **Note.** See Chapter 13, "IRC §199 — Qualified Production Activities Deduction," for complete information on this deduction.

The IRC §199 qualified production activities deduction (QPAD) was a part of the American Jobs Creation Act of 2004. It was first claimed on 2005 tax returns. The final regulations for §199 were issued on May 24, 2006, and are effective for tax years beginning on or after June 1, 2006.

TIPRA makes a change in the definition of qualifying Form W-2 wages to include only those related to the qualifying activity producing the domestic production gross receipts. Prior to TIPRA, the taxpayer could include all wages in the QPAD computation.

Example 8. All Star Manufacturing produces widgets for domestic sale. All Star also imports whatsits from China, which it sells in the United States. All Star has qualifying W-2 wages for their widget employees of $112,000 and W-2 wages for its whatsit employees of $30,000. In 2005, All Star could use a total wage of $142,000 when computing its QPAD. In 2006, they are limited to $112,000.

S corporation shareholders who are allocated part of the qualified production activities income (QPAI) of the corporation are treated as being allocated their share of the W-2 wages. The allocation is limited though to wages used to determine QPAI. The same is true for partnerships who allocate QPAI to partners.

Prior to the TIPRA change, S corporation shareholders and partnership partners were limited in the amount of pass-through wages qualifying for the QPAD. The limit was two times the amount of QPAI passed-through and reported on Schedule K-1.

Example 9. Hector is a 50% shareholder of TimeStar Producers. TimeStar has QPAI of $300,000 and qualifying W-2 wages of $100,000. In 2005 Hector was limited to using $9,000 [(6% × $300,000) × 50%)] of TimeStar wages in computing his QPAD. In 2006, he can use the full $50,000 (50% × $100,000) reported on the K-1.

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11. IRC §6049(b)(2)(B)

Repeal of Foreign Sales Corporation (FSC) and Extra Territorial Income (ETI) Exclusion Binding Contracts

The qualified production activities deduction was a result of the repeal of the FSC and ETI deductions. The repeal allowed a continuation for written, binding contracts which were already in place at the time of repeal. The repeal of ETI included a gradual decrease in the exclusion for future year production. It allowed an exclusion credit for 2005 and 60% for 2006. TIPRA eliminates any exclusion for the binding contracts, but still allows the 60% credit for 2006.

Observation. The repeal is the result of continuing pressure from the World Trade Organization.

CORPORATE PROVISIONS

Parts of the provisions of TIPRA affect only corporations.

Controlled Foreign Corporations

The first of these provisions relates to controlled foreign corporations (CFCs) and exempts dividends, interest, rents, and royalties from Subchapter F taxation by providing look-through treatment. This applies only to CFCs receiving the dividends, interest, rents, and royalties from another CFC to the extent attributable to non-Subchapter F income of the payor.

The act contains other provisions relating to CFCs.

Corporate Spin-Offs

Generally, a distribution of property from a corporation to its shareholder is a taxable transaction. However, a corporate spin-off of stock or securities of a controlled corporation under IRC §355 can be tax-free but requires that the corporation qualify as an active trade or business. Under the old law, the test required both the distributing corporation and the controlled corporation be an active trade or business after the distribution.

The new law allows distributions made between the date of enactment and December 31, 2010, to qualify as tax-free by treating all corporations in the controlled group as a single corporation. This will prevent the need of a corporation to restructure to meet the active trade or business requirement.

The new TIPRA rules do not apply to disqualified investment corporations or a person who did not own a 50% or greater interest before the distribution, but holds a 50% or greater interest after the distribution.

Corporate Estimated Payments

The number of estimated tax payments and the amount of these payments by large corporations is changed. The change is due to budgetary considerations. A large corporation is one with assets of $1 billion or more.

Future Year Provisions

Some of the provisions of TIPRA are not effective until 2007 and later years. The time delay is partially due to budgetary issues. For example, the withholding issue is expected to generate substantial revenue, which will offset the revenue losses of other provisions.

Withholding on Government Payments

Federal, state, and local government entities are required to withhold 3% income tax on certain government payments and grants made after 2010. This is required for payments for property and services. There is an exemption for political subdivisions having less than $100 million in annual expenditures.

If backup withholding is already required for the payment, the 3% is not withheld. The withholding covers voucher and certificate programs as well. In the past, commodity certificate payments were not included on Form 1099 G. While the payment is still exempt from the 1099 filing requirement, it is liable for withholding. The withholding does not apply to needs-based public welfare or assistance programs. However, they do apply to payments for health care and other services which are not based on need. There is an exclusion for interest payments, intragovernmental payments, and payments under a classified or confidential contract.

Note. Congress views the new withholding requirements as a revenue enhancer.

ENERGY POLICY ACT OF 2005

The Energy Policy Act of 2005 contained a subtitle known as the Energy Tax Incentives Act of 2005 (ETIA). Many of the provisions first come into being for tax years beginning January 1, 2006. The following discusses these provisions.

Note. Additional details are available in the *2005 Federal Tax Workbook,* Chapter 12, "New Legislation."

ALTERNATIVE MOTOR VEHICLE CREDITS

The ETIA replaced the deductions for alternative motor vehicles with the sum of four different credits beginning in 2006. The four vehicle energy credits have three requirements in common.

1. The taxpayer must be the first user of the vehicle.
2. The vehicle must be acquired for use or lease by the taxpayer and it cannot be purchased for resale.
3. The vehicle must be made by a manufacturer.

1. Qualified Fuel Cell Motor Vehicle Credit

This credit only applies to motor vehicles powered by energy created by combining oxygen and hydrogen.[12] The credit ranges from $8,000 to $40,000 depending on the weight of the vehicle. Vehicles classified as "passenger automobiles" and "light trucks" can increase the amount of the credit between $1,000 and $4,000. The increased credit is based on fuel efficiency tables derived from 2002 model year fuel efficiencies.

For example, the credit is increased by $1,000 if the efficiency is between 150% and 175% of the 2002 amount. The credit is increased by $4,000 if the efficiency is 300% or more of the 2002 amount.

While the credit for fuel cell vehicles is substantial, taxpayers may not find qualifying vehicle at their local automobile dealership for a few years.

2. Advanced Lean-Burn Technology Motor Vehicle Credit

The credit applies to vehicles that use compression ignition diesel technology. This means the vehicle operates using more air than is necessary for complete combustion. This technology may not be available until 2007 or later years when cleaner diesel fuel becomes available and manufacturers have improved emission control systems.

12. IRC §30B(b)(3)(A)

In addition to meeting the three requirements common to all of the new credits, a lean-burn vehicle must meet three additional requirements. It must:

1. Be designed to use more air than is necessary for complete combustion of the fuel,
2. Incorporate direct injection, and
3. 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.

3. 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, but not all, 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.

> **Note.** See the “Credits” section of Chapter 15, “Rulings and Cases” for detailed information.

The number of hybrid vehicle models is continually increasing. Current information regarding various models and their specifications can be found at **www.whybuyhybrid.com.** The applicable credits are shown on **www.fueleconomy.gov.**

4. Qualified Alternative Fuel Motor Vehicle Credit

The term **alternative fuel** means compressed natural gas, liquefied petroleum gas, hydrogen, and any liquid at least 85% of the volume of which consists of methanol. The latter is commonly known as “M85.”

The alternative fuel credit is available for qualified vehicles placed in service from 2006 through 2010. The credit amount is calculated as the applicable percentage of the incremental cost of any new vehicle placed into service during the year.

There is a reduced credit available to mixed-fuel vehicles. These are vehicles which can run on an alternative fuel or a petroleum-based fuel. The credit available is a percentage of the credit available to alternative fuel vehicles. The percentage is determined by the percentage of alternative fuel used.

> **Note.** E85 flexible fuel vehicles do not qualify for the Qualified Alternative Fuel Motor Vehicle Credit in 2006.

CLEAN FUEL VEHICLE REFUELING PROPERTY

The Energy Tax Incentives Act of 2005 (ETIA) established a new credit permitting taxpayers to recover a portion of the cost of purchasing clean-fuel vehicle refueling property. Effective January 1, 2006, this **credit** replaces the **deduction**[13] for clean-fuel vehicles and certain refueling property allowed under IRC §179A. This credit applies to any qualified property placed in service after December 31, 2005, and before January 1, 2010.[14]

13. IRC §179A

14. Property relating to hydrogen may qualify if placed in service prior to January 1, 2015.

Taxpayers use Form 8911, *Alternative Fuel Vehicle Refueling Property Credit*, to claim the credit. It is available to help both businesses and individuals defray the cost of purchasing clean-fuel refueling property for either retail or residential use. However, the dollar limitation is lower for personal use property. The credit equals 30% of the property's cost, limited to:

- $30,000 for depreciable property, and
- $1,000 for personal use property.

Qualified property must be used in the United States. The property must be new, with use originating with the taxpayer claiming the credit. However an exception applies to property owned or used by a tax-exempt organization, governmental unit, or foreign person or entity.[15] A taxpayer that **sells** property to one of the aforementioned excepted groups may claim the credit, unless the property is leased. To be eligible, the seller must clearly disclose to the purchaser the amount of the credit the seller is entitled to receive for the property.

Qualified property must be used for one of the following two purposes:

1. To store and/or dispense clean-burning fuel onsite directly into the tank of a motor vehicle propelled by such fuel, or
2. To recharge electric vehicles.[16]

To be considered clean-burning fuel, a mixture must meet one of the following definitions:

- Any fuel at least 85% of the volume of which consists of one or more of the following: ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen; or
- Any mixture of biodiesel[17] or renewable diesel and diesel fuel,[18] determined without regard to any use of kerosene and containing at least 20% biodiesel or renewable diesel.

The amount of any credit attributable to depreciable property is treated as a general business credit. The amount of any credit that is not attributable to depreciable property is treated as a personal credit. It is allowable to the extent it does not exceed the excess (if any) of the taxpayer's regular tax reduced by the **sum of the following credits:**

- Foreign tax credit,
- Qualified electric vehicle credit, and
- Alternative motor vehicle credits, including:
    - 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,

divided by the taxpayer's AMT liability for the taxable year.

A taxpayer must reduce the basis of qualified property by the amount of any credit claimed unless the taxpayer elects out of the credit. The credit is subject to recapture if the property ceases to be eligible for the credit, such as with property that is modified so it no longer stores or dispenses clean-burning fuel.[19]

15. As described in IRC §50(b)(3)-(4)
16. IRC 179A(d)(3)
17. Defined in IRC §40A(d)(1)
18. Defined in IRC §4083(a)(3)
19. IRC §30C(e)(5) provides that recapture rules similar to the rules of Treas. Reg. §1.179A- 1 shall apply.

Form **8910** Department of the Treasury Internal Revenue Service	**Alternative Motor Vehicle Credit** ▶ Attach to your tax return.	OMB No. 1545-1998 **2006** Attachment Sequence No. **152**

Name(s) shown on return | **Identifying number**

Part I **Tentative Credit**

Use a separate column for each vehicle. If you need more columns, use additional Forms 8910 and include the totals on lines 8 and 12.		(a)	(b)	(c)
1 Year, make, and model of vehicle	1			
2 Enter date vehicle was placed in service (MM/DD/YYYY)	2	/ /	/ /	/ /
3 Maximum credit allowable (see instructions)	3			
4 Phaseout percentage (see instructions)	4	%	%	%
5 **Tentative credit.** Multiply line 3 by line 4	5			

Part II **Credit for Business/Investment Use Part of Vehicle**

6 Business/investment use percentage (see instructions)	6	%	%	%
7 Multiply line 5 by line 6	7			
8 Add columns (a) through (c) on line 7			8	
9 Alternative motor vehicle credit from partnerships and S corporations			9	
10 **Business/investment use part of credit.** Add lines 8 and 9. Partnerships and S corporations, report this amount on Schedule K; all others, report this amount on Form 3800, line 1v			10	

Form **8911** Department of the Treasury Internal Revenue Service	**Alternative Fuel Vehicle Refueling Property Credit** ▶ Attach to your tax return.	OMB No. 1545-1981 **2006** Attachment Sequence No. **151**

Name(s) shown on return | **Identifying number**

Part I **Total Cost of Refueling Property**

1 Total cost of qualified alternative fuel vehicle refueling property placed in service during the tax year	1	

Part II **Credit for Business/Investment Use Part of Refueling Property**

2 Business/investment use part (see instructions)	2	
3 Section 179 expense deduction (see instructions)	3	
4 Subtract line 3 from line 2	4	
5 Multiply line 4 by 30% (.30)	5	
6 Maximum business/investment use part of credit (see instructions)	6	
7 Enter the **smaller** of line 5 or line 6	7	
8 Alternative fuel vehicle refueling property credit from partnerships and S corporations	8	
9 **Business/investment use part of credit.** Add lines 7 and 8. Partnerships and S corporations, report this amount on Schedule K; all others, report this amount on Form 3800, line 1w	9	

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SMALL AGRI-BIODIESEL PRODUCER AND RENEWABLE DIESEL CREDITS

Note. Additional information on these credits is found in Chapter 12, "Agricultural Issues and Rural Investments."

The ETIA added two new credits to the tax code for small producers of agri-biodiesel fuel and for users and sellers of renewable diesel fuel. Both credits are available in tax year 2006. The producer's credit became effective for tax years ending after August 28, 2005. The renewable diesel fuel credit is available for fuel sold or used after December 31, 2005.

These credits join the biodiesel fuels credit enacted under the American Jobs Creation Act of 2004 (AJCA). The AJCA credit was due to sunset on December 31, 2006; however, the ETIA extended the biodiesel fuels credit through December 31, 2008. Taxpayers use Form 8864, *Biodiesel and Renewable Diesel Fuels Credit*, to claim these credits.

With the introduction of the new ETIA credits, there are now three components to the biodiesel fuels credit allowed under IRC §40A. These components include:

- The biodiesel mixture credit,
- The biodiesel credit (including the renewable diesel credit), and
- The small agri-biodiesel producer credit.

The new credits are based on biodiesel or renewable diesel fuels used as fuel in a trade or business or sold at retail to others who use the fuels to operate their vehicles. The credit cannot be claimed twice (i.e., no credit is allowed for business consumers who purchase fuel from a retailer who is claiming the credit).

All producers and importers of biodiesel or renewable diesel and producers of blended taxable fuel are required to be registered with the IRS through Form 637, *Application for Registration (For Certain Excise Tax Activities)*. Taxpayers who file Form 720, *Quarterly Federal Excise Tax Return;* Form 8849, *Claim for Refund of Excise Taxes;* or Form 4136, *Credit for Federal Tax Paid on Fuels*, cannot use the same fuel to claim a credit on Form 8864.

A portion of the biodiesel fuel and renewable diesel fuels credit relating to any gallon of fuel on which the credit was based is subject to recapture if any of the following events occur:

- The fuel (including a mixture) is used for a non-fuel purpose;
- The fuel is bought at retail and used to create a mixture;
- The fuel is separated from a mixture; or
- Any agri-biodiesel fuel on which the small agri-biodiesel producer's credit was claimed is used for a nonqualified purpose.

Small Agri-Biodiesel Producer Credit

Agri-biodiesel fuel is a special type of biodiesel[20] fuel derived exclusively from animal fats and certain vegetable oils, including esters derived from virgin corn, soybean, sunflower seed, cottonseed, canola, crambe, rapeseed, safflower, flaxseed, rice bran, and mustard seed oils.

20. Biodiesel means the monoalkyl esters of long-chain fatty acids derived from plant or animal matter which meet the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (EPA) under §211 of the Clean Air Act and the requirements of the American Society of Testing and Materials (ASTM) D6751.

The qualified small agri-biodiesel production credit is available to eligible **small producers**, defined as producers with an agri-biodiesel production capacity that does not exceed 60 million gallons at any time during the tax year. To qualify for the credit, the agri-biodiesel must be either sold to a person other than the producer for, or used personally by the producer for, one of the following purposes:

- For use in the production of a qualified biodiesel mixture in the other person's trade or business (not including casual off-farm production),
- For use as a fuel in the other person's trade or business, or
- For use as a retail product dispensed directly into customers' fuel tanks at the other person's business.

The small agri-biodiesel producer **credit is equal to 10¢ for each gallon of qualified production**. The credit is **limited to 15 million gallons per year**, per eligible producer. For purposes of this limitation, and the small-producer threshold of 60 million gallons per year, all members of the same controlled group of corporations[21] and all persons under common control[22] are treated as one person. These limitations apply at both the entity and taxpayer levels for partnerships, S corporations, and other pass-through entities.[23]

Facilities with shared ownership interests may allocate production per regulations to be prescribed. Cooperative organizations may elect to allocate any portion of the credit to patrons on a pro rata basis. The tax treatment and special rules affecting cooperatives and patrons can be found at IRC §40A(e)(6).

Renewable Diesel Credit

Renewable diesel means diesel fuel derived from any organic material **other than** oil, natural gas, or coal, including lignite, or any byproduct of these resources, using a thermal depolymerization process.[24] For purposes of the renewable diesel credit, renewable diesel receives the same tax treatment as biodiesel, except the credit allowance for renewable diesel is **$1 per gallon**. The biodiesel credit is 50¢ per gallon.

To qualify for this credit, biodiesel fuel cannot be mixed with diesel fuel. The fuel also must be used either by the taxpayer as fuel in a trade or business or sold and dispensed directly into a customer's motor fuel tank at the taxpayer's retail business. No credit is allowed for fuel used in a trade or business that was purchased at the retail business of a taxpayer claiming the credit.

> **Caution.** Renewable diesel and biodiesel used or sold for use in a diesel-powered highway vehicle or diesel-powered train may be subject to a 24.4¢ per gallon federal excise tax. This tax liability is reported on Form 720, line 60(b).

Certification. Any taxpayer claiming a biodiesel fuel credit after August 29, 2005, must obtain from the producer or importer of the fuel a **Certificate for Biodiesel** and, if applicable, a **Statement of Biodiesel Retailer** to attach to Form 8864. Each certificate must identify the product produced and the percentage of biodiesel and agri-biodiesel in the product.

21. Determined under IRC §267(f)
22. Determined under IRC §52(b), but treating an interest of more than 50% as a controlling interest
23. IRC §40A(e)(3)
24. This process must meet the registration requirements for fuels and fuel additives established by the EPA under §211 of the Clean Air Act and the requirements of ASTM D975 or D396.

For the renewable diesel credit, documentation must include a certificate from the producer identifying the product as renewable diesel and, if applicable, a statement from the reseller. If a certificate was attached to a previously filed return, in lieu of the certificate a taxpayer may include a statement with the following information:

- The certificate identification number
- The total number of gallons claimed on Form 8849, Schedule 3
- The total number of gallons claimed on Form 720, Schedule C
- The total number of gallons claimed on Form 4136

IRS Notice 2005-65[25] modifies previous notices[26] to reflect the revised certification requirements in effect as of August 29, 2005. This notice provides several model certification statements for producers to use.

HOMEOWNER ENERGY CREDITS

The ETIA created, or rather recreated, two energy credits for homeowners effective January 1, 2006, through December 31, 2007:

1. The nonbusiness energy property credit,[27] more commonly referred to as the residential energy property credit, and
2. The credit for solar energy systems.[28]

These credits are essentially updated versions of energy credits that have been unavailable to homeowners since 1985.

Congress narrowed the availability of these new credits to calendar years 2006 and 2007 in an effort to spur consumers into quick action. The credits are available for home improvements made to reduce energy consumption and are intended to help defray the cost of energy saving devices that will in turn offer consumers continuously lower energy bills.

Many states also offer tax incentives for energy efficiency and renewable energy resources. The Database of State Incentives for Renewable Energy (DSIRE) offers a comprehensive source of information on state, local, utility, and selected federal incentives that promote renewable energy. This database can be accessed at **www.dsireusa.org.**

1. Residential Energy Property Credit

The residential energy property credit allows taxpayers to recover a portion of the cost of purchasing, and sometimes installing, energy efficient products in their homes. This nonbusiness credit has two components, each with its own distinctive set of rules and limitations. The two components are:

a. Qualified energy efficiency improvements, and

b. Residential energy property expenditures.

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25. IRS Notice 2005-65, IRB 2005-35, August 29, 2005

26. IRS Notice 2005-4, 2005-2 IRB 289, as modified by Notice 2005-24, 2005-12 IRB 757

27. IRC §25C

28. IRC §25D

Common Qualification Requirements. Both residential energy property expenditures and qualified energy efficiency improvements share some common overall qualification requirements. Both components require qualified energy efficiency measures to be:

- Originally placed in service by the taxpayer claiming the credit, and
- Installed in or on a dwelling unit that is:
  - Owned and used by the taxpayer as his principal residence,[29] and
  - Located in the United States.

a. Qualified Energy Efficiency Improvements

Qualified energy efficiency improvements encompass certain modifications made to a building's envelope with components that are designed specifically and primarily to reduce a dwelling unit's heat loss or gain. Manufactured homes must conform to federal safety standards[30] to be included in this definition of a dwelling unit.

To meet the "specific and primary design" test, production costs attributable to features other than those that reduce heat loss or gain cannot exceed production costs attributable to features that reduce heat loss or gain. The "specific and primary design" test was expanded to include a facts and circumstances test for deciphering an improvement's primary design purpose.[31]

This notice indicates that taxpayers may rely on a manufacturer's certification that a siding product is an eligible building envelope component only through June 26, 2006. After that date, manufacturers may no longer certify siding for the credit.

As provided in the Code,[32] a **building envelope component** consists of:

- Insulation materials or systems, including any vapor retarder or seal to limit infiltration,
- Exterior windows, including storm windows and skylights,
- Exterior doors, and
- Metal roofs with certain pigmented coatings.

To be qualified, a taxpayer must have a reasonable expectation that the component(s) will remain in use for at least five years. All relevant facts and circumstances are taken into account when applying this "reasonable expectation" rule. In lieu of this requirement, any component for which a manufacturer complimentarily provides a 2-year warranty covering the repair or replacement of the component will automatically satisfy the 5-year reasonable expectation test.[33]

Additionally, these improvements must be made with energy efficient items that meet certain specific performance, quality, and certification standards. These standards are set forth by regulation and must meet or exceed standards set by either the 2001 supplement to the 2000 International Energy Conservation Code (IECC) or to the 2004 supplement to the 2003 IECC.[34]

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29. Principal residence, as used in IRC §25C, has the same meaning as given in IRC §121.
30. Federal Manufactured Home Construction and Safety Standards as set forth at 24 CFR §3280
31. Notice 2006-53, June 2, 2006
32. IRC §25C(c)(2)
33. Notice 2006-26, §4.05(3); IRB 2006-11, February 21, 2006
34. Notice 2006-26, §3, February 21, 2006

Energy Star. Energy Star is a joint program of the Environmental Protection Agency (EPA) and the Department of Energy (DOE). It was established to help businesses and individuals protect the environment and achieve cost savings through the use of energy efficient products and practices. The program provides consumers with energy consumption information by labeling products that meet strict energy efficiency criteria with the Energy Star logo.

A metal roof with pigmented coating will qualify as an energy efficiency improvement if it meets the Energy Star program requirements. Taxpayers may also rely on Energy Star labels for exterior windows and skylights that meet or exceed the IECC criteria for the region where they are to be installed.[35] This information is identified on the product label. Additional information on qualifying building envelope components for each U.S. climate zone region is available at **www.efficientwindows.org/energystar.cfm** or **http://tinyurl.com/rhmvw.**

The Energy Star website provides a detailed chart summarizing the energy tax credits available to homeowners, including detailed specifications for each product type. This chart can be accessed at **www.energystar.gov/index.cfm?c=products.pr_tax_credits** or **http://tinyurl.com/8oeno.**

> **Caution.** Not all products bearing the Energy Star label are eligible for the residential energy property credit. The credit is available only for certain products that meet the highest energy efficiency ratios.

Certification. Manufacturers may provide consumers with certification of a product's eligibility for the credit. Taxpayers may rely on a manufacturer's certification if the qualified energy property is installed in a manner consistent with the product's certification guidelines.[36]

The IRS reserves the right to monitor this certification process and publish announcements that may revoke certification privileges for manufacturers that provide false statements of eligibility. However, taxpayers may rely on certifications provided prior to an IRS announcement withdrawing a manufacturer's certification rights. Erroneous certifications may result in penalties to the manufacturer.[37]

It is not necessary to attach a certification form to the tax return. However, taxpayers should retain any certifications they receive as part of their tax return records to substantiate their credit in the event of an IRS examination.

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35. Notice 2006-26, §4.03, February 21, 2006

36. Notice 2006-26, §4.02(3), February 21, 2006

37. Notice 2006-26, §4.02(6), February 21, 2006

b. Residential Energy Property Expenditures

Residential energy property expenditures are defined as costs incurred by a taxpayer for qualified energy property. **Qualified energy property** is a term used in the code that encompasses the following energy savings devices:

- Certain electric heat pump water heaters[38]
- Certain electric heat pumps[39]
- Certain geothermal heat pumps[40]
- Certain central air conditioning units[41]
- Qualified hot water boilers or natural gas, propane, or oil furnaces[42]
- Advanced main air circulating fans[43]

Qualified energy property must meet certain performance and quality standards in effect at the time the taxpayer acquires the property or completes construction, reconstruction, or erection of the property. These standards are promulgated by regulation and must meet certain minimum statutory requirements.[44]

Note. As this chapter was being written, no regulations on this topic were available. However, IRS Notices 2006-26 (February 21, 2006) and 2006-53 (June 2, 2006) set forth interim guidance pending the issuance of any regulations.

Credit Computation

The **nonrefundable** residential energy property credit equals the sum of:

- 10% of the cost of qualified energy efficiency improvements, plus
- 100% of the cost of residential energy property expenditures.

However, this credit is subject to two types of **limitations**: an aggregate, lifetime limitation and a component category limitation. The maximum lifetime limitation is $500 per taxpayer, taking into account the taxpayer's combined residential energy property credits over the two year eligibility period.

Individual limitations also apply to several types of components. Within the $500 lifetime limitation, the following categorical sublimitations also apply:

Component Classification	Component Description	Credit Limitation
Improvement	Exterior windows, storm windows, and skylights	$200
Expenditure	Advanced main air circulating fan	50
Expenditure	Qualified natural gas, propane, or oil furnace or hot water boiler	150
Expenditure	Any item of energy-efficient building property	300

38. IRC §25C(d)(3)(A)
39. IRC §25C(d)(3)(B)
40. IRC §25C(d)(3)(C)
41. IRC §25C(d)(3)(D)
42. IRC §§25C(d)(3)(E) and 25C(d)(4)
43. IRC §25C(d)(5)
44. These requirements are set forth in IRC §25C(d)(2)(C).

Installation Costs.[45] The cost of residential energy property expenditures may include labor costs allocated to the onsite preparation, assembly, or original installation of qualified energy property. However, installation costs may not be included when calculating the credit for building envelope components.[46]

Special Rule for Condominiums and Cooperative Dwelling Units.[47] The Code sets forth a special rule for jointly owned structures consisting of two or more units. This rule allows taxpayers who jointly own energy property shared by two or more dwellings units to individually compute their limitations, with each owner being entitled to a separate $500 lifetime maximum credit.

Joint Occupancy of a Single Dwelling Unit.[48] Joint occupants of a single dwelling unit are treated as one taxpayer for purposes of the credit limitations. In the case of multiple occupants who are not filing a joint return, each qualified individual may claim a credit corresponding to his share of the overall credit amount, according to the following formula:

$$\text{Individual Credit Amount} = \text{Overall Credit Amount} \times \frac{\text{Co-Owners Qualified Expenses}}{\text{Total Qualified Expenses for All Owners}}$$

Mixed Business/Personal Use of Component.[49] If any qualifying component is used 20% or more for business purposes, a taxpayer must allocate the cost of the item between personal and business uses. Only the cost of the item allocated to personal use qualifies for this credit.

Timing and Amount of Expenditures.[50] Expenses are eligible for the residential energy property credit when the original installation of the component is completed. In the event the component is installed during construction or remodeling of a residence, the cost of the component becomes eligible for the credit when the structure is first used by the taxpayer. Before the credit is calculated, eligible expenditures must be reduced by the amount of any subsidized energy financing[51] the taxpayer receives.

Basis Adjustments. The basis of the taxpayer's residence is increased by any energy-efficiency expenditure or improvement added to the property, but reduced by the amount of any allowable energy credit claimed on the property.

Additional Information. For more information on qualifying products, visit the Tax Incentives Assistance Project's (TIAP) website at **www.energytaxincentives.org**. TIAP is a coalition of public interest nonprofit groups, government agencies, and other organizations in the energy efficiency field dedicated to providing consumers with the information necessary to take advantage of the federal income tax incentives provided under the Energy Policy Act of 2005.

Note. As of the printing date of this chapter, the IRS had not yet published information regarding the form number or instructions necessary to claim the residential energy property credit.

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45. IRC §25C(d)
46. Notice 2006-26, §4.06, February 21, 2006
47. IRC §25C(e)(2)
48. Applying similar rules to IRC §25D(e)4 per §25C(e)(1)
49. Applying a rule similar to IRC §25D(e)(7) per §25C(e)(1)
50. Applying rules similar to IRC §25D(e)(8)-(9) per §25C(e)(1)
51. IRC §48(a)(4)(C)

2. Personal Residence Solar and Fuel Cell Credits

The ETIA also provides a credit for homeowners who purchase certain solar water heaters, photovoltaic property, or qualified fuel cell property. The term "qualified fuel cell property" means a fuel cell power plant which has a nameplate capacity of at least 0.5 kilowatt of electricity using an electrochemical process, and has an electricity-only generation efficiency greater than 30%.[52] Photovoltaic (PV) property, commonly referred to as solar cell property, converts sunlight into direct current (DC) electricity. Fuel cells use a chemical reaction, rather than combustion, to produce electricity in a process that combines hydrogen and oxygen.[53]

The nonrefundable credit for these types of residential energy efficient properties is equal to the sum of the following:

- 30% of qualified photovoltaic property expenditures, limited to a maximum credit of $2,000;
- 30% of qualified solar water heater expenditures, limited to a maximum credit of $2,000, and
- 30% of qualified fuel cell expenditures limited to a $500 credit for each half kilowatt of capacity.

To be qualified, solar water heaters must derive half their energy use from the sun and be certified for performance by the nonprofit Solar Rating Certification Corporation[54] or a comparable entity endorsed by the state in which the property is located. Both solar water heaters and photovoltaic property must be used in the U. S. residence of the taxpayer claiming the credit; however, qualified fuel cell property must be installed on or in connection with the taxpayer's **principal** U.S. residence to qualify.

Installation Expenses. Labor charges allocated to the onsite preparation, assembly, or original installation of property qualified for the credit are taken into account when computing the credit, as are costs associated with piping and wiring to connect such property to the residence. Solar collection panels that constitute a structural component of a roof can qualify for the credit, but expenditures allocated to swimming pools or hot tubs shall only qualify if these items are used for no other purposes than energy storage mediums.

Special Rules. Joint occupants of a residence are treated as one taxpayer when computing the credit limitations, with each occupant allowed his pro rata share of the individual credit components. Tenants of cooperative housing corporations and condominiums are also allowed their proportionate share of the total credit. This credit applies to nonbusiness use items only — the cost of mixed use property must be allocated if 20% or more of the item's usage is attributable to business.

Expenses are eligible for the residential solar, photovoltaic, and fuel cell credit when the original installation of the component is completed. In the event the component is installed during construction or remodeling of a residence, the cost of the component becomes eligible for the credit when the structure is first used by the taxpayer. Before the credit is calculated, eligible expenditures must be reduced by the amount of any subsidized energy financing the taxpayer receives.

Carryover of Credit. Although this credit is nonrefundable, IRC §25D(c) provides for a carryforward of any amount of unused credit to succeeding taxable years. Although the form has not yet been released by the IRS, it is rumored that Form 5698 will be resurrected for this purpose.

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52. IRC §48(c)(1)
53. More information about fuel cells is located on the U.S. Fuel Cell Council website at www.usfcc.com.
54. www.solar-rating.org

Loopholes and Fine Points. Although the energy credits enacted under the ETIA do not apply until tax year 2006, an American Bar Association (ABA) subcommittee on taxation convened with representatives from Capitol Hill and the IRS in May of 2006 to discuss the implications of the new energy tax incentives.[55] This group identified several quirks in the law, including:

- Equipment used to heat outdoor hot tubs is ineligible for the solar energy credit, but equipment used to heat indoor jacuzzis qualifies for the credit.
- The renewable energy credit is not subject to recapture.
- There is no provision stating a taxpayer is required to continue using a renewable energy source after the credit is awarded.

CLEAN RENEWABLE ENERGY BOND HOLDER CREDIT

The ETIA added §54 to the Code, authorizing the issuance of up to $800 million of clean renewable energy bonds (CREBs) to finance certain renewable energy projects in 2006 and 2007. CREBs are not tax-exempt bonds, but rather **tax credit** bonds, which allow bond holders to receive an income tax credit in lieu of interest payments.

The projects that may be funded with these bonds are described in IRC §45(d) and include the following energy-production facilities, if qualified:

- Wind facilities
- Closed-loop biomass facilities
- Open-loop biomass facilities
- Geothermal or solar energy facilities
- Small irrigation power facilities
- Landfill gas facilities
- Trash combustion facilities
- Refined coal production facilities
- Hydropower facilities
- Indian coal production facilities

These bonds may be issued by qualified clean renewable energy lenders, cooperative electric companies, or governmental bodies that have been allocated a portion of the $800 million national allowance.[56] Authorized borrowers, including certain mutual or cooperative electric companies and government bodies, must comply with certain rules relating to expenditures to qualify for the prescribed tax treatment for CREBs.[57]

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55. *Verdict on Usefulness of Energy Tax Act Incentives Withheld as Quirks and Loopholes Debated,* 2006TAXDAY, Item #M.3, May 9, 2006

56. The IRS provides additional guidance for issuers and borrowers in Notice 2005-98, 2005-IRB 1211 (December 27, 2005) and Notice 2006-7, 2006-IRB 385 (February 16, 2006).

57. IRC §54(h)

Credit Computation. Taxpayers who are holders of CREBs on one or more credit allowance dates are allowed a nonrefundable tax credit for a portion of the bond interest that otherwise would have been due. Bond issuers do not have to actually pay interest on these bonds, but rather the credit is applied in lieu of any interest payments. However, taxpayers are required to include the amount of the credit in gross income, treating the amount as interest income.[58]

Credit allowance dates fall quarterly, on the following schedule:

- March 15
- June 15
- September 15
- December 15

Credit allowance dates also include the last date on which the bond is outstanding. Bonds issued, redeemed, or maturing between these credit allowance dates receive a prorated credit for that period. The annual credit is computed by multiplying the face amount of the bond by a credit rate to be determined by the IRS. This daily credit rate reflects the IRS's estimate of the rate of return for a bond issued with a specified maturity or redemption date, without regard for discounts or interest costs to the issuer.

The total credit allowed is the sum of credits for each credit allowance period. The credit allowed for each period is equivalent to 25% of the annual credit amount, prorated if necessary. If the credit is received via a pass-through entity, the credit amount cannot exceed the tax attributable to the taxpayer's portion of income from the entity. The pass-through entity limitation rules are similar to the rules limiting the pass-through of the research credit.[59] The credit is claimed on the same form as the Gulf bond credit — Form 8912, *Clean Renewable Energy Bond Credit and Gulf Bond Credit.*

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58. IRC §54(g)

59. IRC §41(g)

Form **8912**
(February 2006)
Department of the Treasury
Internal Revenue Service

Clean Renewable Energy Bond Credit and Gulf Bond Credit

► Attach to your tax return.

OMB No. 1545-XXXX

Name | Employer identification number

Part I Current Year Credit

Section A. Clean Renewable Energy Bond Credit

	(a) Bond issuer's name, city or town, and state	(b) Date bond issued	(c) Date bond disposed of	(d) Outstanding bond principal	(e) Credit rate	(f) Credit ((d) x (e))	(g) %	(h) (f) x (g)
1								

2	**Total credit.** Add the amounts on line 1, column (h). See the instructions for how to report as interest income	2	
3	Clean renewable energy bond credits from S corporations, partnerships, estates, or trusts (see instructions)	3	
4	**Current year clean renewable energy bond credit.** Add line 2 and line 3. Pass-through entities not completing Section B, see instructions	4	

Section B. Gulf Bond Credit

	(a) Bond issuer's name, city or town, and state	(b) Date bond issued	(c) Date bond disposed of	(d) Outstanding bond principal	(e) Credit rate	(f) Credit ((d) x (e))	(g) %	(h) (f) x (g)
5								

6	**Total credit.** Add the amounts on line 5, column (h). See the instructions for how to report as interest income	6	
7	Gulf bond credits from S corporations, partnerships, estates, or trusts (see instructions)	7	
8	**Current year Gulf bond credit.** Add line 6 and line 7. Pass-through entities, see instructions	8	

For Paperwork Reduction Act Notice, see instructions. Cat. No. 37722B Form **8912** (2-2006)

Form **8912** (2-2006) Page **2**

Part II **Allowable Credit**

9	Regular tax before credits: • Individuals. Enter the amount from Form 1040, line 44 • Corporations. Enter the amount from Form 1120, Schedule J, line 3, or the applicable line of your return • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b, or the amount from the applicable line of your return		**9**	
10	Alternative minimum tax: • Individuals. Enter the amount from Form 6251, line 35 • Corporations. Enter the amount from Form 4626, line 14 • Estates and trusts. Enter the amount from Form 1041, Schedule I, line 56		**10**	
11	Add line 9 and line 10		**11**	
12a	Foreign tax credit	**12a**		
b	Credits from Form 1040, lines 48 through 54	**12b**		
c	Possessions tax credit (Form 5735, line 17 or 27)	**12c**		
d	Qualified electric vehicle credit (Form 8834, line 20)	**12d**		
e	Other specified credits (see instructions)	**12e**		
f	General business credit (see instructions)	**12f**		
g	Credit for prior year minimum tax	**12g**		
h	Qualified zone academy bond credit (attach Form 8860)	**12h**		
i	Add lines 12a through 12h		**12i**	
13	Net income tax. Subtract line 12i from line 11		**13**	
14	**Clean renewable energy bond credit allowed for the current year.** Enter the smaller of line 4 or line 13 (if line 13 is smaller than line 4, see instructions). Report this amount (plus the amount, if any, from line 16 below) on Form 1040, line 55; Form 1120, Schedule J, line 6f; Form 1041, Schedule G, line 3; or the applicable line of your return **Note:** If line 8 is zero or blank, stop here.		**14**	
15	Subtract line 14 from line 13		**15**	
16	**Gulf bond credit allowed for the current year.** Enter the smaller of line 8 or line 15 (if line 15 is smaller than line 8, see instructions). Report this amount (plus the amount, if any, from line 14 above) on Form 1040, line 55; Form 1120, Schedule J, line 6f; Form 1041, Schedule G, line 3; or the applicable line of your return		**16**	

Form **8912** (2-2006)

ENERGY EFFICIENT NEW HOMES

The credit for energy efficient new homes is available to eligible contractors engaged in the construction of qualified energy efficient homes and to **producers** of qualified manufactured homes. The credit is effective from January 1, 2006, through December 31, 2007.

To qualify as an energy efficient home, a residence must meet the standards of IRC §45L(c) **and** be:

- Located in the United States;
- Substantially completed after August 8, 2005; and
- Purchased from the contractor by an individual for use as a residence after December 31, 2005, and before January 1, 2008.

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A credit applies to each qualifying home constructed or produced. The term **construction** encompasses the creation of or substantial reconstruction or rehabilitation of a dwelling unit. The amount of the credit is determined according to the level of energy efficiency each home is projected to achieve, as established by the separate criteria of subsections (1) through (3) of §45L(c). A **$2,000 credit** applies to each dwelling unit that meets the criteria of §45L(c)(1) and (2):

- **IRC §45L(c)(1)** requires each unit:
  - To be certified to consume at least **50% less** energy for heating and cooling than comparable units;
  - To be constructed in accordance with the standards of section 404 of the 2004 supplement to the 2003 IECC; and
  - To contain building envelope component improvements that are at least 10% more energy efficient than those of comparable dwelling units.
- **IRC §45(c)(2)** requires that a manufactured home conform to the federal Manufactured Home Construction and Safety Standards[60] and meet the energy efficiency standards of §45L(c)(1).

A **$1,000 credit** applies to each dwelling unit that meets the criteria of **§45(c)(3)**. This subsection requires a manufactured home conform to the federal Manufactured Home Construction and Safety Standards[61] and meet the following reduced energy-efficiency standards:

- To be certified to consume at least **30% less** energy for heating and cooling than comparable units;
- To be constructed in accordance with the standards of section 404 of the 2004 supplement to the 2003 IECC; and
- To contain building envelope component improvements that are at least 10% more energy efficient than those of comparable dwelling units; **or**
- To be a certified Energy Star home.

Notice 2006-27 defines **building envelope components** as any building element that encloses conditioned space, including any boundary between conditioned and unconditioned space, including:

- Basement or exterior walls,
- Floors, and
- Roofs.

> **Note.** This notice sets forth the process for obtaining certification for the credit and provides a public list of software programs certifiers may use to calculate energy consumption. Contractors do not need to attach certificates to their tax returns, but must retain these certifications to substantiate any credit claimed.

This credit is claimed on Form 8908, *Energy Efficient Home Credit*, and carried to Form 3800, *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, but any unused credits may be carried forward for 20 years.

60. 24 CFR 3280

61. 24 CFR 3280

Form **8908** (Rev. December 2006) Department of the Treasury Internal Revenue Service

Energy Efficient Home Credit

▶ Attach to your tax return.

OMB No. 1545-1979

Attachment Sequence No. **153**

Name(s) as shown on return	Identifying number

1a	Enter the total number of qualified energy efficient homes meeting the 50% standard that were sold during the tax year (see instructions)	**1a**		
b	Multiply line 1a by $2,000		**1b**	
2a	Enter the total number of qualified energy efficient manufactured homes meeting the 30% standard that were sold during the tax year (see instructions)	**2a**		
b	Multiply line 2a by $1,000		**2b**	
3	Energy efficient home credit from partnerships and S corporations		**3**	
4	Add lines 1b, 2b, and 3. Partnerships and S corporations, report this amount on Schedule K; all others, report this amount on the applicable line of Form 3800 (e.g., line 1t of the 2006 Form 3800)		**4**	

ENERGY EFFICIENT COMMERCIAL BUILDING DEDUCTION

IRC §179D provides a **deduction** for qualifying energy efficient **commercial** building property placed in service after December 31, 2005, and before January 1, 2008. The full deduction is equal to the cost of qualified property up to an aggregate lifetime limitation of **$1.80 per square foot** of the commercial building where the property is installed. A partial deduction of **$0.60 per square foot** is allowed for certain expenditures.

A building may be a new or existing structure. The deduction limitation is placed on the building. If two or more taxpayers install qualified property on the same building, the overall limitation of $1.80 per square foot still applies.[62] Basis of property must be reduced by the amount of any deduction claimed.

The deduction may be claimed by the taxpayer who bears the cost of construction. This is usually the building owner, but it also may include a tenant. If qualified expenditures are paid by a public entity, such as a school, the deduction may be claimed by the person primarily responsible for designing the property.

Qualifying Energy Efficient Commercial Building Property

To be eligible for the deduction, energy efficient commercial building property must be:

- Depreciable;
- Installed on a building that is located in the United States;
- Installed on a building that is constructed 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 (ASHRAE);
- Installed as part of one the following building components:
  - Interior lighting system;
  - Heating, cooling, ventilation, and hot water systems; or
  - Building envelope; **and**
- Certified as being installed as part of a plan designed to reduce the total annual energy and power costs for the above items by 50% or more in comparison to a comparable reference building.

62. IRS Notice 2006-52, June 2, 2006 revised June 26, 2006

The required 50% reduction must be accomplished solely through energy and power cost reductions for the heating, cooling, ventilation, hot water, and interior lighting systems. Reductions in any other energy uses, such as receptacles, process loads, refrigeration, cooking, and elevators, are not taken into account in determining whether the 50% reduction is achieved.[63]

Partial Deduction

A partial deduction of **$0.60 per square foot** is allowed for certain expenditures that do not meet the 50% energy savings requirement. The rules for the partial deduction are complex. IRS Notice 2006-52 §§2.03, 2.04, and 2.05 provide detailed instructions regarding both permanent and interim rules for each component (i.e., lighting, heating/cooling/ventilation/hot water, and building envelope).

ENERGY EFFICIENT APPLIANCES CREDIT

IRC §45M provides a credit for **manufacturers** of certain energy efficient appliances. This credit is claimed on Form 8909, *Energy Efficient Appliance Credit*, and provides a credit for certain qualified energy efficient dishwashers, clothes washers, and refrigerators produced in calendar year 2006 or 2007.

Note. There is no comparable credit for purchasers of these energy efficient appliances.

BUSINESS SOLAR INVESTMENT CREDIT

The **business** solar investment tax credit increases from 10% to 30% for solar energy property, hybrid solar lighting systems, and qualified fuel cell property. Hybrid solar lighting systems consist of equipment that uses fiberoptic-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. These provisions are effective for periods after December 31, 2005, and before January 1, 2008.

PENSION PROTECTION ACT OF 2006

The 393-page Pension Protection Act of 2006 (PPA) was signed by the President on August 17, 2006. It is touted as the most comprehensive pension legislation in more than 30 years. The PPA initiates changes to retirement plans, and also makes major changes in the area of charitable contributions and provisions relating to the Tax Court. It is estimated that the act will cost over $66.4 billion for the period 2007 through 2016.

The PPA is designed to encourage Americans to save additional monies for their retirement. It is also intended to increase retirement security for both current employees and retirees by changing the funding requirements for defined benefit pension plans, increasing premiums to the Pension Benefit Guaranty Corporation (PBGC), and imposing larger penalties on employers who under-fund defined benefit pension plans.

Caution. The PPA is too voluminous and complex to discuss all of its contents in detail. Practitioners who have clients with defined benefit plans are encouraged to thoroughly read the act. A technical explanation of the PPA prepared by the staff of the Joint Committee on Taxation can be found at **http://www.house.gov/jct/x-38-06.pdf.**

63. Ibid

DEFINED BENEFIT PLANS

A **defined benefit plan** promises a fixed, pre-established benefit at retirement. The benefit amount is often based on a set percentage of pay multiplied by the number of years an employee works for an employer. Defined benefit plans are often referred to as "company pensions." These plans are usually funded solely by employers, with contributions based on actuarial assumptions. Defined benefit plans require employers to assume the risk of maintaining sufficient funding to guarantee retirement benefits to employees.

By contrast, a **defined contribution plan** does not promise a specific benefit amount at retirement. In these types of plans, employees, employers, or both contribute to individual employee accounts. The employee assumes the risk with a defined contribution plan, since the actual benefit depends on the amount invested and the investment performance of the funding vehicle. Employers may maintain both defined benefit plans and defined contribution plans.

Approximately 44 million people are covered by traditional, defined benefit pension plans. Typically, these plans cover people who are or were employees of manufacturing companies. Many of these companies are now in severe financial trouble. Consequently, they are turning their plans over to the PBGC for administration, thereby depleting its funds.

> **Observation.** Recently, many large employers have turned away from defined benefit pension plans in favor of 401(k) and similarly-typed plans. The PPA may encourage this trend and cause more employers to abandon their defined benefit plans.

Minimum Funding Standards

Employers are subject to minimum funding requirements for defined benefit plans and must make contributions on a quarterly basis or pay an interest penalty. Minimum funding requirements are determined by comparing the plans assets to the plan's liabilities. Gains and losses on investments are credited to the plan, along with **forfeitures** of other employees' accounts. If an employer is a member of a controlled group, each member has joint and several liability for plan contributions.

The PPA establishes new minimum funding standards for defined benefit plans, requiring most plans to become **fully funded over seven years**. Under-funded plans must contribute the present value of accrued benefits and the amount of any shortfall amortized over seven years, plus interest. These provisions do not apply if an under-funded amount is less than $1 million.

These standards may be waived under certain business hardship conditions. However, the standards cannot be waived for more than 3-out-of-15 years for a single-employer plan or 5-out-of-15 years for a multiemployer plan. Amounts granted for waivers must be amortized over a 5-year period. An employer may be required to provide security for a plan before a waiver is granted.

Deduction Limit

The PPA increases the contribution limit for defined benefit plans. The limit differs depending on whether a plan is a single or a multi-employer plan. M**ulti-employer plans** are collectively bargained and maintained by more than one employer (usually within the same or related industries) and a labor union.

Prior to the PPA, an employer generally could deduct up to 100% of a plan's current actuarial liability. Excess contributions were subject to a 10% excise tax. The PPA increases the maximum deductible amount to 150% of current liability for plans beginning in 2006 or 2007. The deduction limit for multiemployer plans increases to 140% of current liability. The maximum limit for contributions cannot be less than the current under-funded plan balance.

Beginning in 2008, allowable contributions can include the calculated funding liability, costs, and a **"cushion"** equal to 50% of the target liability projected with compensation increases over the value of the plan's assets. These additional deductible contribution limits encourage larger contributions than are required to keep a plan in compliance and may help to protect pension benefits if an employer suffers an economic downturn.

Funding Requirement Exceptions

The pension funding requirements are amended for certain types of businesses, including interurban or interstate bus transportation, commercial passenger airlines, and catering firms servicing commercial passenger airlines. There are also exceptions for certain government contractors.

SUNSET DATE REPEALED ON PARTS OF EGTRRA

The Economic Growth and Tax Relief Act of 2001 (EGTRRA) contained many provisions relating to pension and retirement plans that were scheduled to end on December 31, 2010. The PPA removed these sunset dates and made the provisions permanent. However, some EGTRRA provisions still have a 2010 sunset date.

Some of the major EGTRRA provisions that were made **permanent** include:

1. **Designated Roth** 401(k) and 403(b) plans
2. Section 529 qualified tuition plans
3. Credits:
   - Pension plan **start-up credit** for small employers
   - **Retirement saver's** credit
4. **Catch-up contributions** for taxpayers age 50 and over (the $1,000 IRA contribution is not inflation adjusted; the $2,500 SIMPLE and $5,000 elective deferral plan catch-up contributions will be inflation adjusted in $500 increments)
5. IRAs:
   - Increased IRA contribution limits (inflation adjusted after 2008)
   - Rules relating to deemed IRAs under employer plans
6. **Elective deferral plans**:
   - Increased elective deferral contribution limits (e.g., SIMPLE, §401(k), and §457 plans)
   - Increased dollar limits on combined employer and employee contributions to defined contribution plans
   - Increased, inflation-adjusted employer deduction limits for retirement plan contributions
   - Enhanced portability of §403(b) and §457 plans
   - Application of prohibited transaction rules to plan loans of S corporation owners, partners, and sole proprietors
   - Provisions relating to hardship distributions
7. **Enhanced rollover rules**:
   - Direct rollovers from IRAs to employer plans
   - Rollovers of after-tax contributions
   - Rollovers from §457 and §403(b) plans or cash-outs
   - Expanded waiver rules regarding 60-day rollover period

8. **Pension plan administration**:
   - Modification of top-heavy rules
   - Faster vesting of employer matching contributions
   - Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations
   - Elimination of user fee for requests to IRS regarding pension plans
   - Certain nonresident aliens excluded in applying minimum coverage requirements
   - Treatment of employer-provided retirement advice
9. **Other retirement provisions**:
   - Modification of minimum distribution rules
   - Clarification of tax treatment of division of §457 plan benefits upon divorce
   - Purchase of service credits under governmental pension plans

IRA PROVISIONS

Direct Deposit of Tax Refunds to an IRA

Many tax professionals advise their clients to contribute to an IRA. However, their clients may not have funds available to make contributions. If a taxpayer files early in the year, he normally receives his refund before the IRA contribution deadline. This is especially true if the tax refund is directly deposited.

For tax years beginning after December 31, 2006, taxpayers can authorize the IRS to **directly deposit refunds into retirement accounts** (i.e., IRAs, qualified retirement plans, §403(b) annuities, or §457 plans). With the split refund option available on the new Form 8888, *Direct Deposit of Refund*, taxpayers can split their refund among up to three accounts. This option will allow taxpayers who are married filing jointly to direct a portion of their joint refund into their respective retirement accounts. (Details on Form 8888 are provided elsewhere in this chapter.)

> **Caution.** To be currently deductible, the IRA contribution must be made by April 15. This requirement did not change with the PPA. Therefore, the taxpayer must file early enough to ensure the tax refund is deposited by the deadline.

Additional IRA Contributions for Certain Employees

The PPA allows certain employees to make additional §401(k) contributions in 2007, 2008, and 2009. Qualified individuals are those who participated in a **bankrupt** employer's §401(k) plan and received **at least 50% matching contributions** from the employer in the form of the employer's stock. Additionally, the employer must have been:

- A debtor in bankruptcy in the preceding year; and
- Subject to indictment or conviction resulting from business transactions related to the case.

An employee must have been a participant in the plan at least six months before the bankruptcy was filed. The additional contribution amount can be up to $3,000.

> **Observation.** While this provision is advantageous to former employees of companies such as Enron, will these individuals have the money to make the contributions?

OTHER RETIREMENT PROVISIONS

Saver's Credit Modifications

The PPA makes the saver's credit a **permanent** part of the tax code. The credit was previously scheduled to expire at the end of 2006. It also enhances the saver's credit by **indexing the AGI eligibility threshold** for inflation beginning in 2007. The amount of the credit is not indexed.

Permissive Service Credit Purchases

The PPA expanded the rights of government employees to purchase service credits to increase their retirement benefits. Credits now qualify as permissive service credits if they are purchased to provide an increased benefit for a period of service already credited under the plan (e.g., if a lower level of benefit is converted to a higher benefit level otherwise offered under the same plan) as long as it relates to benefits to which the participant is not otherwise entitled. This increases the portability of retirement benefits from one governmental entity to another.

Investment Advice

Currently, regulations prohibit transactions between a retirement plan and a disqualified person. **Disqualified persons** include:

- Individuals who exercise authority or control over the disposition or management of a plan's assets
- Investment advisors who offer fee-based advice on plan assets or money
- Individuals who have discretionary responsibility or authority in administering a plan

Prohibited transactions include:

- Selling, leasing or exchanging plan property
- Lending transactions
- Furnishing goods, services, or facilities
- Using the plan's assets or income to benefit the fiduciary's own account or interest
- Receiving benefits from any other firm or individual doing business with the plan

The PPA adds an **exemption** to the list of prohibited transactions. This new exemption **permits fiduciaries** holding §401(k), IRA, and similar retirement funds **to offer investment advise to accountholders**. However, fiduciaries may not advise employers on which funds and investments to include in their plans. Advisors are **prohibited** from varying the advisory fee on the basis of any investment selected. This provision is effective for advice provided after 2006.

The PPA also authorizes the IRS and Department of Labor to study computer models for providing investment advice on IRAs and similar plans.

Rollovers of After-Tax Contributions

Current law allows an employee to directly rollover after-tax contributions from one defined benefit plan to another defined benefit plan. It also allows rollovers from defined contribution plans to other defined contributions plans. The same is true for tax-sheltered annuity rollovers.

The PPA allows the **direct** rollover of **after-tax contributions** from any qualified retirement plan funds into either a defined contribution plan, a defined benefit plan, or a tax-sheltered annuity. The plan to which the rollover is made must separately account for after-tax contributions and earnings. This provision is effective for tax years beginning after December 31, 2006.

Direct Rollovers from Retirement Plans to Roth IRAs

The IRS previously allowed certain taxpayers to roll their traditional IRA into a Roth IRA without assessing an early distribution penalty. However, the taxpayer was required to include the amount of the distribution in current taxable income.

Under the PPA, the same rules apply, except **any type of retirement plan can be rolled into a Roth IRA.** However, the $100,000 AGI limit continues to apply. The provision is effective for distributions after 2006.

Hardship and Unforeseen Financial Emergency Rules

To avoid an early distribution penalty from a §401(k), §457, or similarly-typed retirement plan, a taxpayer or his spouse must meet either a hardship or unforeseen circumstances test. The PPA changes this law to include **any beneficiary under the plan.**

Distributions to Reservists Called to Active Duty

Barring exceptions, participants receiving distributions from qualified retirement plans before death, disability, or the attainment of age 59½ are assessed a 10% penalty. The amount of the distribution must be included in gross income for the year received.

The PPA excludes **qualified reservist distributions** from the 10% penalty. To be considered a qualified reservist distribution, a withdrawal must meet all of the following requirements:

1. The distribution must be from an IRA or an elective deferral plan, such as a 401(k) or 403(b).
2. The withdrawal must be made by an individual who meets the following qualifications:
   a. A member of a "**reserve component**" as defined in 37 USC §101, as follows:
      - Army National Guard of the United States;
      - Army Reserve;
      - Naval Reserve;
      - Marine Corps Reserve;
      - Air National Guard of the United States;
      - Air Force Reserve;
      - Coast Guard Reserve; or
      - Reserve Corps of the Public Health Service;

   b. Called or ordered to active duty for a period **in excess of 179 days** or for an **indefinite** period
3. The distribution must be made during the period beginning on the date the reservist was called or ordered to active duty and ending at the close of the active duty period.

A qualified individual has **two years after his ending service date to recontribute** an amount to his retirement plan, not to exceed the amount of the qualified reservist distribution. The recontribution amount cannot be deducted from gross income. The recontribution amount does not reduce the plan contribution limit for the tax year of the recontribution.

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This provision is effective for reservists called or ordered to active duty **after September 11, 2001 and before December 31, 2007**. Since the provision applies **retroactively** to distributions made after September 11, 2001, the period for making retroactive recontributions extends two years after the date of enactment, or August 17, 2008.

The PPA waives the statute of limitations for any claims for refunds or credits resulting from this provision. However, claims must be filed within one year of the date of enactment, or August 17, 2007, to receive the waiver.

Modification of Early Distribution Requirement for Public Safety Employees

Unless an exception applies, individuals receiving nonqualified retirement plan distributions are assessed a 10% early distribution penalty. Qualified distributions are those received by a taxpayer who is:

- At least 59½ years of age
- Over age 55 and separated from service, or
- Receiving distributions as a series of equal periodic payments based on life expectancy.

The PPA alters this rule for public safety employees taking distributions from **governmental, defined benefit retirement plans**. The alteration **reduces the "separation from service" age limit from 55 to 50** for qualified public safety employees who work for state or political subdivisions and who provide police protection, firefighting services, or emergency medical services.

Rollovers by Nonspousal Beneficiaries

Owners of retirement plans or IRAs are eligible to rollover plan funds into other retirement plans or IRAs on a tax-free basis if they meet certain requirements, such as the 60-day rollover window. A surviving spouse also qualifies to rollover any plan funds inherited from a deceased plan or IRA owner. However, prior to the enactment of the PPA, nonspousal beneficiaries were not eligible to rollover inherited funds.

The PPA now **allows nonspousal beneficiaries to rollover inherited qualified plan distributions into IRAs.** The rolled over amount is treated as an inherited IRA of a nonspousal beneficiary and is subject to the same rules applicable to beneficiaries. The **PPA did not change the minimum distribution rules for nonspousal beneficiaries**. This provision is effective for distributions after December 31, 2006.

Use of Excess Pension Assets for Retiree Health Benefits

Once assets are transferred into a defined benefit retirement plan, employers may not access these funds. Funds that revert to an employer are subject to excise tax rates up to 50%. The PPA **allows employers to transfer excess plan assets into retiree medical accounts to fund the expected medical benefit costs for current and future years.**

Self-Annuitizing Church Plans

Minimum distribution rules apply to annuity contracts purchased from insurance companies. However, some churches self-annuitize their plans. The PPA **provides that qualified church plans do not fail the minimum distribution test because they are not maintained by an insurance company.** A qualified church plan is defined as a money purchase plan in which a §410(d) election was not made, and the plan was in existence on April 17, 2002. The §410(d) election includes church plans in participation, vesting and funding regulations.

Diversification Rights for Defined Contribution Plans

The act requires certain defined contribution plans to **provide diversification rights for amounts invested in employer securities.** These diversification rights apply to publicly-traded employer securities, and allow employees to invest in alternative investments. This right applies to the employee and beneficiaries of the employee who are entitled to exercise the rights of the employee.

The rules contain various percentages and elections. The new rules are effective for plan years beginning after December 31, 2006.

Automatic Enrollment in Salary Deferral Arrangements

Most defined contribution plans include a salary deferral option, which allows employees to voluntarily direct their employers to contribute a portion of their salary into a retirement plan. However, some plans provide an **automatic enrollment feature**, which automatically enrolls an employee in an "elective" deferral plan at a default contribution percentage. In order to change the default percentage or stop plan contributions, an employee must opt out of the automatic enrollment feature.

As a means to prevent a company's top management from receiving a disproportionate share of a plan's benefits, the IRS developed nondiscrimination rules. These rules provide tests to determine if a plan is "top heavy." One test compares the contribution percentage of the highly-compensated employees and the nonhighly-compensated employees. This is referred to as the **actual deferral percentage (ADP) test.** The **actual contributions percentage (ACP) test** is used to compare the employer-matching contributions of the two groups. In addition, there are safe harbor rules which allow an employer to meet the discrimination tests.

The PPA exempts qualified plans with automatic enrollment features from the top heavy rules. These plans are **deemed to meet both the ADP test and the ACP test.** A qualified automatic enrollment feature must meet certain requirements with respect to:

- Automatic deferral;
- Matching or nonelective contributions; and
- Notice to employees.

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

Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements

The act provides rules for plans which have the features of both a defined benefit plan and a 401(k) plan.

Faster Vesting of Nonelective Employer Contributions

Employer-provided retirement plans are subject to vesting rules. Vesting determines when an employee has a right to the amounts contributed by his employer or to the amounts in a matching contribution account. Employers are given the option of two different vesting schedules. Prior to the PPA, employer-match contributions were subject to a faster vesting schedule than employer contributions.

The PPA provides a uniform vesting schedule for both employer contributions and employer-match contributions. The new schedule generally applies to contributions for plan years beginning after December 31, 2006. Employees must have an **hour** of service after the effective date.

The following chart compares both vesting schedule options under the old and new laws:

	Schedule 1		Schedule 2	
	Old Law	New Law	Old Law	New Law
Employer Contributions				
End of Year 1				
End of Year 2				20%
End of Year 3		100%	20%	40%
End of Year 4			40%	60%
End of Year 5	100%		60%	80%
End of Year 6			50%	100%
End of Year 7			100%	
Employer-Match Contributions				
End of Year 1				
End of Year 2			20%	20%
End of Year 3	100%	100%	40%	40%
End of Year 4			60%	60%
End of Year 5			80%	80%
End of Year 6			100%	100%
End of Year 7				

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> **Observation.** The accelerated vesting schedule may increase the cost to an employer. It may mean fewer dollars available from employee forfeitures, which are currently used to reduce future contributions.

Working Retirement Distributions

Normally, an employee cannot continue to work and receive distributions from a pension plan unless he reaches his company's normal retirement age (commonly age 65). He may qualify for a phased retirement at age 59½, if he reduces his work hours by 20%.

The PPA **lowers the age 65 requirement to age 62.** This provision is effective for distributions in plan years beginning after December 31, 2006.

New Regulations for Qualified Domestic Relations Orders (QDROs)

An employee cannot assign retirement benefits to a creditor. However, there is an exception to this rule in the event of a qualified domestic relations order (QDRO). Under a QDRO, benefits can be assigned to a former spouse or alternate payee. The law is silent on whether a second QDRO may be issued, as in the case of a second divorce.

The PPA requires the IRS to issue regulations providing that a second or revised QDRO can be treated as a QDRO even though it is issued after another QDRO, or it revises a QDRO. This provision begins on the date of enactment, August 17, 2006.

Former Spouse Benefits under Railroad Retirement

Generally, a former spouse of a railroad employee could not receive any benefits under Tier I (social security equivalent benefit) or Tier II (railroad pension) until the railroad-employed spouse started to collect benefits. A former spouse who survived a railroad-employed spouse lost eligibility for Tier II benefits upon the death of the railroad employee.

The PPA eliminates the requirement that a railroad employee must be collecting benefits before his former spouse is entitled to benefits. It also allows former spouses to retain eligibility for Tier II benefits upon the death of the railroad-employed spouse. This provision becomes effective one year after the date of enactment, or August 17, 2007.

Requirement for Additional Survivor Annuity Option

Unless an employee and spouse agree, money purchase and defined benefit plans are required to provide for a qualified joint and survivor annuity (QJSA). A QJSA pays retirement benefits during the life of the retiree and provides an annuity for the survivor in an amount between 50% and 100% of the amount paid to the retiree. If an employee dies before retirement age, the plan must provide payments to the spouse that are not less than what would have been paid to the retiree. This is called a qualified pre-retirement survivor annuity.

The PPA **revises the minimum survivor annuity requirements.** It allows an employee to opt to be paid in the form of a qualified optional survivor annuity, which is the actuarial equivalent of a single-life annuity based on the life of the participant. This option allows the retiree to receive an annuity for life and the surviving spouse to be paid a percentage of that amount during the joint lives of both the participant and spouse.

This provision is generally effective for years beginning after December 31, 2007.

Form 5500 Filing Exemption Expanded

The PPA increases the asset value limitation for exempting one-participant plans from filing Form 5500, *Annual Return/ Report of Employee Benefits Plan*, from $100,000 to **$250,000.**

Rollover Distributions Cannot Reduce Unemployment Benefits

The PPA prohibits states from reducing unemployment compensation benefits when a taxpayer rolls an IRA or other retirement plan into another plan. This provision is effective for weeks beginning on or after the date of enactment, August 17, 2006.

Public Safety Officers Allowed Tax-Free Distributions for Insurance

The PPA allows eligible **retired** public safety officers to annually exclude up to $3,000 of qualified retirement withdrawals, if the distributions are used to pay for **health or long-term care insurance** for the retiree, his spouse, or dependents. To qualify, premiums must be deducted from distributions and paid directly to the carrier.

Eligible retirement plans include government qualified retirement or annuity plans, such as §457 plans and §403(b) annuities. Eligible taxpayers are public safety officers[64] who are separated from the service of the employer who maintains the pension plan from which the distributions are received, by reason of disability or the attainment of normal retirement age.

This tax treatment is effective for distributions withdrawn in tax years after December 31, 2006.

OTHER PROVISIONS

Taxability of Excess Death Benefits from Company-Owned Life Insurance

Life insurance proceeds are generally not included in a recipient's taxable income. This is true regardless of whether a beneficiary is an individual, corporation, partnership, trust, or the estate of the insured. Pre-PPA law did not include any notification or separation requirements.

The PPA established new rules for policies issued after August 17, 2006. Death benefits in excess of premiums and costs are now taxable to **policyholders.** However, this new income inclusion **rule does not apply under certain circumstances, if notice and consent requirements are met.**

The following three conditions must be satisfied to qualify for the notice and consent exception:

1. The policyholder must provide the employee with written notification that the policyholder intends to insure the life of the employee, stating the face amount of the intended insurance policy.
2. The policyholder must obtain the employee's written consent to being insured stating that the policy may be continued after the employee terminates employment with the policyholder.
3. The policyholder must provide written notification to the employee that the policyholder will be the beneficiary of the insurance.

If notice and consent requirements have been met, the income inclusion rule **does not apply** to excess death benefits received under any of the following four circumstances:

1. The insured was an employee within 12 months of his death;
2. The insured was a highly-compensated employee (i.e., an employee who is a 5% or more owner, one who makes more than $100,000 in the prior year, a director, or an employee ranked in the top 35% of employees by pay);
3. The insurance amount is paid to a family member of the insured, an individual designated as a beneficiary (other than the policyholder), a trust or the insured's estate; or
4. The amount is used to purchase the insured's partnership interest from a family member, beneficiary, trust, or estate of the insured.

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64. The term "public safety officer" is defined in §1204(8)(A) of the Omnibus Crime Control and Safe Streets Act of 1986.

Long-Term Care Insurance

The PPA provides **rules for the tax treatment of long-term care riders on life insurance policies.** If the cash surrender value of an annuity or life insurance contract is used as a payment for long-term care insurance, the value is not included in taxable income. The investment in the contract is reduced by the charge.

If an annuity or life insurance contract is exchanged for an annuity or life insurance contract with a long-term care rider, the exchange can still be tax-free. Any charge against the cash surrender value cannot be deducted as a medical expense.

The provisions are effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009. The provisions relating to tax-free exchanges apply with respect to exchanges occurring after December 31, 2009.

Independent Contractor Status of College Test Proctors

Prior to the enactment of the PPA, the IRS was prohibited from challenging any employer's treatment of an individual as an independent contractor if the employer had a reasonable basis for the treatment and consistently treated the individual and those who provided similar services as independent contractors.

The PPA **amended the consistency requirement** with respect to services performed by test room supervisors and test proctors of college entrance and placement exams. The amendment prohibits the IRS from challenging the independent contractor status of these individuals, even if they were previously treated as employees. This provision applies to individuals providing services for tax-exempt organizations whom are not otherwise employed by the organization. This provision is effective for remuneration paid for services performed after December 31, 2006.

Penalties Increased for Tardy Split-Interest Trusts

The PPA **increases penalties for split-interest trusts that are filed late.** These include charitable remainder annuity trusts, charitable remainder unitrusts, unitrusts, and pooled income funds. The PPA increases the penalty from $10 per day to $20 per day, and increases the maximum penalty from $5,000 to $10,000. If a trust has gross income in excess of $250,000, the penalty is $100 per day up to a maximum of $50,000.

CHARITABLE CONTRIBUTION PROVISIONS

Tax-Free Distributions from IRAs for Charitable Contributions

The PPA provides an exclusion from gross income for taxable IRA distributions contributed to qualified charities by taxpayers **age 70½ or over**. However, the exclusion only applies to contributions **up to $100,000 per year.**

These distributions are taken into account when calculating a taxpayer's required minimum distribution (RMD) but **do not** count against a taxpayer's charitable contribution limitation. Trustees must distribute contributions **directly** to charities.

> **Example 10.** Martha directs the trustee of her traditional IRA to make a $100,000 distribution directly to her church. Martha is 75 years old. Consequently, the distribution is not included in her gross income and does not affect her charitable contribution deduction on her return. However, the distribution does count toward her RMD.

If a taxpayer has a basis in his IRA, contributions are considered to come first from nonbasis assets. These are amounts that were deductible when contributed and would otherwise be taxable upon distribution.

Example 11. Tom, age 71, has a traditional IRA with a $90,000 balance. His IRA consists of $10,000 of nondeductible contributions and $80,000 of deductible contributions. Tom directs his trustee to make an $80,000 distribution to his church.

Since contributions are deducted first from taxable distributions, Tom does not include any of the $80,000 distribution in his gross income. The contribution does not reduce Tom's charitable contribution limit and he retains his $10,000 nontaxable basis in his IRA.

This provision is effective for charitable distributions made **after December 31, 2005 and before January 1, 2008.**

Effect of Donations on S Corporation Stock Basis

Prior to enactment of the PPA, an S corporation shareholder could claim a prorated share of any contribution made by the S corporation on his tax return. However, the shareholder was required to reduce the basis of his stock by the corresponding amount of any pass-through contribution.

The PPA specifies that shareholders now must reduce the basis of their stock by the **basis of any property donated.**

Example 12. Tammy Corporation, a single-participant S corporation, contributed IBM stock valued at $5,000 with a basis of $2,000 to a qualified charity. Tammy claims the $5,000 pass-through charitable deduction, but must only reduce her Tammy Corporation stock basis by $2,000.

This provision is effective for tax years beginning **after December 31, 2005 and ending before January 1, 2008.**

Food Inventory

Currently, the value of any inventory item donated to charity is the lesser of the item's basis or its fair market value (FMV). C corporations can claim an enhanced deduction for certain types of inventory, generally limited to 10% of taxable income. The enhanced deduction is the lesser of:

1. The item's basis plus one-half of its appreciation, or
2. Two times the item's basis.

The Katrina Emergency Tax Relief Act of 2005 (KETRA) allowed any taxpayer engaged in a trade or business to become eligible for the enhanced deduction for "apparently wholesome" food inventory donations made between August 28, 2005 and December 31, 2005. However, the deduction for non-C corporation taxpayers cannot exceed 10% of the taxpayer's net taxable income from the trade or business entity that contributed the inventory.

The PPA **extends this KETRA provision** through years ending before **January 1, 2008.**

Book Inventory

KETRA extended an enhanced charitable contribution to C corporations who donated qualified books to public schools providing education for grades K – 12. However, this deduction only covered book donations through December 31, 2005. The PPA **extends this deduction through December 31, 2007.**

Real Property Donated for Conservation Purposes

The PPA increases the charitable deduction for taxpayers who donate **real property** used for **conservation**. Capital gain property contributed by an individual is normally subject to a 30% contribution base limit if valued at FMV. This **limit is increased to 50% if the deduction is valued at basis.** Excess contributions can be **carried forward five years.**

Taxpayers are generally not entitled to a deduction if they contribute less than an entire interest in the property. The **partial interest rule does not apply to a qualified conservation donations.** Qualified conservation donations are donations of a qualified real property interest to an eligible organization for bona fide conservation purposes.

A **qualified real property** interest is:

- The entire interest of a donor, other than mineral interests;
- A remainder interest; or
- An "in perpetuity" restriction of the use of the property.

Qualified conservation purposes include:

- The preservation of land for the public for educational use or outdoor recreation
- The protection of a natural habitat
- The preservation of open space yielding public benefit for scenic enjoyment or governmental policy
- The preservation of historical land or structures

The PPA does not limit the conservation property deduction to 30% of the contribution base, but **allows individuals to deduct the FMV of the property up to 50% of the contribution base over the amount of other allowable charitable contributions.** An individual can carry any excess conservation contribution over for **15 years.**

The limit is **increased to 100% if a donor is considered a qualified farmer or ranc**her. To be considered a qualified farmer or rancher, gross income from farming or ranching must be greater than 50% of total gross income for the taxable year.

> **Example 13.** Travis is a qualified farmer. He donates $50,000 of conservation property to a qualified organization. He has a contribution base of $30,000 in the conservation property and makes $20,000 of other contributions which are subject to the 50% limit.
>
> Travis can deduct $15,000 of the $20,000 "other" 50% limit contributions and carry the remaining $5,000 forward for five years. He can also deduct $15,000 ($30,000 × 50%) of the conservation contribution and carry the balance of $35,000 ($50,000 – $15,000) forward up to 15 years.

A nonpublicly-traded corporation with qualifying farming or ranching income can deduct up to 100% of its excess taxable income over the amount of other charitable contributions. It can also carry any excess conservation deduction up to 15 years.

The PPA specifies that **conservation property must remain available for agricultural or livestock production.** This condition does not apply to conservation property donations made between January 1, 2006 and August 17, 2006. The other provisions are effective for donations made after December 31, 2005 and before January 1, 2008.

Easements in Historic Districts

A taxpayer can donate a conservation easement for a property, even his personal residence, if it is located in a historical district. But the PPA placed the following **additional requirements on donations**:

1. There must be a restriction to preserve the entire outer structure of the building, including the space above, not just the front of the building.
2. The donor and donee must both certify that the donee organization is qualified and that it has the commitment and funds necessary to enforce the restrictions.
3. The donor must attach a qualified appraisal of the property and pictures of the property's exterior to his income tax return for the year he claims the tax deduction. He must also include a description of the restrictions on the development of the property.
4. Taxpayers claiming a **deduction in excess of $10,000** for an exterior easement must pay a **fee of $500.**

Charitable deductions must be reduced pro rata by the amount of any **rehabilitation credits claimed** on the property. This reduction ratio is computed by totaling the amount of rehabilitation credits claimed over the last five years and dividing the sum by the amount of the contribution. The result is then multiplied by the FMV of the contribution to arrive at the deduction limitation.

> **Example 14.** Ted plans to donate a conservation easement for a qualified building in the historical district of Atlanta. The building was appraised at $1 million. Ted took rehabilitation credits of $100,000 over the past five years. Ted's contribution deduction is limited to $90,000 or (($100,000 ÷ $1,000,000) × $1,000,000).

The provisions relating to contribution deductions for buildings and land areas and the rehabilitation credit are effective for contributions made after August 17, 2006. The provision relating to the filing fee is effective for contributions made 180 days after January 31, 2007. The other provisions are effective for contributions made after July 25, 2006.

Excise Taxes for Prohibited Tax-Exempt Organization Transactions

Some tax-exempt organizations channel money to disqualified individuals connected with the organization. These transactions are called excess benefit transactions. IRS regulations discourage this type of activity by assessing excise taxes on the individuals and organizational managers involved in these prohibited transactions.

Excise taxes are also imposed on private foundations for self-dealing between a disqualified individual and the foundation. Transactions between disqualified individuals and the private foundation include all of the following:

- Selling, leasing, or exchanging property;
- Lending money;
- Furnishing goods or services;
- Paying compensation;
- Transferring or using income or assets; and
- Making payments to a government official.

Prior to the enactment of the PPA, the excise tax imposed on individuals engaged in self-dealing or excess benefit transactions was 5% of the amount of the transaction. Foundation managers who knowingly participated in these prohibited transactions were assessed an excise tax of 2.5% of the transaction, up to $10,000 per act. If a transaction was not corrected, an additional tax of 200% was imposed on the disqualified individual. In addition, an excise tax of 50%, not to exceed $10,000 per act, was imposed on the organization's manager.

Private non-operating foundations are required to distribute a minimum amount of money each year to accomplish one or more of the organizations exempt purposes. Prior to the PPA, failure to make these required distributions could have resulted in an excise tax of 15% of the undistributed amount. If the distribution was not corrected, the IRS could assess an additional 100% excise tax. There are also excise taxes on excess business holdings, jeopardizing investments and taxable expenditures.

The PPA **doubles the excise tax** on self-dealing to 10% for disqualified individuals and 5% for managers, not to exceed $20,000 per act. The act also doubles the other excise taxes which can be imposed for failure to distribute, excess business holdings, jeopardizing investments, and taxable expenditures.

These increased excise taxes are effective for taxable years beginning after August 17, 2006.

Charitable Contributions of Taxidermy

Charitable donations of taxidermy are treated as tangible personal property. The value of the deduction is predicated on whether the property is used to further the donee's exempt purpose. If so, the deduction for appreciated taxidermy is its FMV. If it is not used to further the donee's tax-exempt purpose, the deduction is limited to the donor's basis in the property.

The PPA provides that the amount of the deduction for taxidermy contributed by the person who stuffed the animal, etc., or the person who paid to have it stuffed is the lesser of the taxpayer's basis or FMV. The basis of the property only includes the cost of having the property prepared, stuffed, or mounted. It does **not include the cost of the hunting or fishing trip** to collect the property, **or the cost of the gun or fishing tackle used in the hunt.**

This provision is effective for contributions made after July 25, 2006.

Recapture of Benefit on Property not used for a Exempt Purpose

Taxpayers are entitled to a charitable deduction equal to the FMV of capital gain property donated to a qualified charitable organization if the charity uses the property for its exempt purpose. The deduction is limited to the property's basis if it is not used for the organization's exempt purpose. If the value of the property is more than $500, the donor must file Form 8283, *Noncash Charitable Contributions.*

Prior to the enactment of the PPA, if an organization disposed of the donated property within two years of the donation, the organization was required to file Form 8282, *Donee Information Return*. This applied to property with a claimed value of more than $5,000.

The PPA now requires donees to file Form 8282 if the property is disposed of **within three years of the donation.** The donor then is required to make an adjustment to the claimed tax benefit. If the disposition is in the tax year of the donation, the donor is only entitled to deduct the basis of the donated property. If the disposition occurs in a later year, the donor must include the difference between the claimed value of the property and the basis of the property in ordinary income.

Example 15. Dan donates a painting by a famous artist to the village museum September 2, 2006. The painting is valued at $85,000, Dan's basis is $10,000. The museum certifies that the painting will be hung in the museum to further the art education of the village residents. On December 3, 2006 the museum board decides it would be better to sell the painting and use the money to remodel the museum.

While the money is used for an exempt purpose, its use does not further the **organization's exempt purpose**. Therefore, Dan must reduce his charitable deduction. He is entitled to a deduction only in the amount of his $10,000 basis in the property, not its $85,000 FMV.

Example 16. Use the same facts as **Example 15**, except the board does not decide to sell the painting until February 18, 2007. Dan deducted the full FMV of $85,000 in 2006, the year before the museum notified Dan of the change in use of his donation. Dan is required to add the $75,000 ($85,000 – $10,000) difference between the claimed donation and his basis to his 2007 gross income.

A tax adjustment is not required if the donee organization certifies that its use of the property was for its exempt purpose, states how the property was used, and how it furthered its purpose. Adjustment are also not required if the exempt organization disposed of the property because it became infeasible to implement its original purpose. To prevent the donor from having to make an adjustment, the exempt organization must file Form 8282. A copy should be furnished to the donor.

Example 17. Use the same facts as **Example 15,** except the board decides to sell the painting because it could not afford to adequately secure it. The board files Form 8282, certifying that it is no longer possible for the painting to be used for its intended purpose. The board provides Dan with a copy of this documentation. Dan is not required to recapture his charitable deduction.

A penalty of $10,000 can be assessed against a person who knowingly misrepresents property as meeting an organization's exempt purpose.

The provision is effective for returns filed and contributions made after September 1, 2006 and the penalty applies for identifications made after August 17, 2006.

Contributions of Clothing and Household Items

Many taxpayers donate used clothing and household items to organizations such as Goodwill and the Salvation Army. Assuming the donated items are not used by the charity for its exempt purpose, the deduction is limited to the lesser of the donor basis or FMV of the property. Normally, the FMV is the smaller amount.

The donor is required to maintain written records of the donation regardless of the donated property's value. If the deduction for the donated property is $250 or more, the taxpayer must have a contemporaneous written acknowledgement by the donee.

The PPA now **prohibits deductions** for charitable contributions of clothing or household goods **unless the items are in good or better used condition.** The IRS has the authority to **deny deductions for items with minimal value**, such as socks and underwear. The IRS reported that in 2003, taxpayers claimed deductions for clothing and household goods in excess of $9 billion.

This provision is effective for donations made after August 17, 2006.

Recordkeeping and Substantiation Requirements

The PPA now requires taxpayers to maintain documented written records of all contributions of money and property **regardless of the amount.** Substantiation may consist of bank records, receipts, or written communications from donors.

Documentation must include all of the following elements:

1. Date of the contribution
2. Name of the donee
3. Amount of the contribution.

> **Observation.** Recordkeeping requirements can no longer be satisfied by keeping a journal of contributions. This seems to eliminate deductions for currency contributions made to church collection plates.

The provision is effective for tax years beginning after August 17, 2006.

Fractional Interests in Tangible Personal Property

A donation of a **partial interest** in property generally does not result in a charitable deduction. A partial interest can be a remainder interest, income interest, or the right to use a property. However, a gift of an **undivided** portion of a donor's entire interest is deductible. The gift is normally given as a tenant in common with a right to possession, dominion, and control over a portion of the property.

The PPA allows donors to **claim charitable deductions for donations of fractional interests** in property (e.g., a 40% interest in a sculpture). The charitable deduction is based on the FMV of the property multiplied by the fractional interest donated. However, donors are required to make **future donations** of interests in the **same** property.

A **donor must own the entire property** for which the fractional interest is being given, with **two exceptions:**

1. The donor owns the property with the donee at the time of contribution, or
2. The donor owns the property with another person who is making an equal donation to the same donee.

Example 18. Fred and Gary each own an undivided interest in a valuable painting. If Fred and Gary each donate a fractional share of their 50% interest to the same donee, the deduction is allowable.

Any charitable deduction, plus interest, must be **recaptured** if a donor fails to donate the remaining interest in the property before the end of **10 years**. The IRS also assesses a **10% penalty** on the recaptured amount. The value of subsequent year's donations of interest in the same property is based on the **lesser** of the valuation made in the initial year or the value of the property in the subsequent year.

This provision is effective for donations made after August 17, 2006.

Penalties for Incorrect Valuations

A taxpayer is required to attach a statement signed by a qualified appraiser for property contributions valued at more than $5,000. There are specific rules regulating qualified appraisers. Congress attempted to curb the overvaluation of property by allowing the IRS to assess penalties in the case of substantial overvaluations.

Prior to the enactment of the PPA, a substantial overvaluation was normally considered twice (200%) the property's actual FMV. The associated penalty is 20% of the underpaid tax resulting from the erroneous valuation. The penalty increased to 40% in the case of a gross overvaluation (400% overvaluation). No penalty is assessed if the overvaluation does not exceed $5,000.

Accuracy-related penalties also apply to substantial and gross undervaluations on estate and gift tax returns, where a substantial understatement was one that was 50% or less than the correct valuation. A gross understatement was one that was 25% or less of the correct amount. The IRS can assess penalties on a person for aiding or abetting a taxpayer in a valuation that results in an underpayment of tax. This penalty is $1,000, but increases to $10,000 if the undervaluation is related to a corporate tax return.

The PPA reduces the threshold for imposing accuracy-related penalties on taxpayers. A **substantial overstatement is now defined as 150% of the correct FMV**, and a **gross overstatement is one that is 200% or greater than the correct FMV**. The PPA also defines a **substantial understatement for estate or gift tax purposes** as a valuation that is **65% or less than the correct FMV**, and a **gross understatement is 40% or less.**

The penalty assessed on the person furnishing an incorrect appraisal is now the greater of $1,000 or 10% of the understatement of tax resulting from the erroneous appraisal. The penalty cannot exceed 125% of the fee received for providing the appraisal.

The effective dates of these provisions are:

- Accuracy-related penalty — returns filed after August 17, 2006
- Penalty on appraiser — returns filed after August 17, 2006
- Appraisals related to donations of an historical easement — returns filed after July 25, 2006

Exemption Standards for Credit Counseling Organizations

New bankruptcy rules require that all individuals filing for bankruptcy protection receive nonprofit budget and credit counseling within 180 days of filing. As a result, the number of companies providing credit counseling services increased.

The IRS announced it audited 41 nonprofit credit counseling services over the past two years. This group represents 40% of the industry's revenue. As a result of these audits, the exempt status of **all** 41 services were either revoked, proposed for revocation, or terminated.

In response to this, the PPA establishes additional regulations credit counseling services must meet in order to obtain tax-exempt status. These new provisions apply to tax years beginning after August 17, 2006.

Annual Information Return Notification Requirements

Prior to enactment of the PPA, many tax-exempt organizations were not required to file returns with the IRS because their annual gross receipts were **less than $25,000.** PPA provisions now require these organizations to **electronically file information** each year. Organizations also must notify the IRS when they terminate.

The following information is required to be filed annually:

- Legal name of the organization;
- Name under which the organization does business;
- Organization's mailing address;
- Organization's web address;
- Taxpayer identification number;
- Principal officer's name and address; and
- Evidence of continuing basis for exemption.

If an organization fails to file for three consecutive years, its tax-exempt status is revoked. Organizations that are currently required to file Form 990, *Return of Organization Exempt from Income Tax*, will also have their exemption revoked for failing to file for three consecutive years.

This provision is effective for notices and returns for annual periods beginning after 2006.

Disclosure to State Officials Relating to §501(c) Organizations

The PPA allows the IRS to disclose more information to state officials regarding exempt organizations.

Exempt Organization UBTI Reports Made Public

Organizations exempt under §501(c) or (d) are required to make their Forms 990, *Return of Organization Exempt From Income Tax*, available for public inspection. However, these organizations were not required to make their Forms 990-T, *Exempt Organization Business Income Tax Return*, regarding unrelated business income available.

The **PPA now requires that Form 990-T also be made available to the public**. This provision is effective for returns filed after August 17, 2006.

Qualified Tuition Programs

The PPA repeals the sunset of §529 plans imposed by TIPRRA. These plans are now a **permanent** part of the tax code.

TAX COURT PROVISIONS

The PPA addresses a number of changes relating to the Tax Court. Some of these provisions deal with technical aspects of the Court and additional fringe benefits for Tax Court judges. These provisions are not covered in this section.

Collection Due Process Cases

The PPA gives the Tax Court full jurisdiction over collection due process cases. These are cases in which a taxpayer contests an IRS notice to levy the taxpayer's property. Depending on the type of tax involved, taxpayers previously would file in either the U.S. Tax Court or the U.S. District Court. If the taxpayer filed in the wrong court, the case would be delayed. This gave taxpayers the opportunity to refile. The PPA now **requires all cases to be filed in Tax Court.**

Practitioner Fees May be Used for Pro Se Services

Individuals practicing before the Tax Court are assessed an annual fee of $30. In the past, this fee was used to employ independent counsel in disciplinary matters. The PPA no longer allows this fee to be used to provide services to pro se taxpayers.

MISCELLANEOUS

TRANSPORTATION WORKERS' MEAL ALLOWANCE

The Taxpayer Relief Act of 1997 initiated a phased increase of meal deductions for transportation workers.[65] The deductible percentage has increased from 55% in 1998 and 1999 to 75% for tax years 2006 and 2007. The final phasein percentage rises to 80% for tax years starting in 2008 and thereafter.

These increased meal allowances apply only to transportation workers who are subject to Department of Transportation hours of service limitations while traveling away from home, such as interstate truck or bus drivers. These workers also include:

- Air transportation employees, such as pilots, crew, dispatchers, mechanics, and control tower operators, under Federal Aviation Administration regulations;
- Railroad employees, including engineers, conductors, train crews, dispatchers, and control operations personnel, under Federal Railroad Administration regulations; and
- Merchant marines under Coast Guard regulations.

Example 19. Melinda, a self-employed long-haul trucker, kept accurate records for her days away from her tax home during 2006. From Jan. 1 through Sept. 30, 2006, she was away from home 175 days. She claims the **CONUS** standard meal allowance of **$52 per day.** Her Schedule C deductible meal expense for the first nine months of 2006 is **$6,825,** as shown below.

175 days away from home × $52 = $9,100 × 75% (deductible % for 2006) = **$6,825**

Her deductible meal expense for the last three months of 2006 is not computed as the updated CONUS standard meal allowance rate was not yet available.

Note. Both the CONUS and OCONUS standard meal allowance amounts for transportation industry workers may change effective October 1, 2006. These updated rates can be found on the Internet at **www.gsa.gov.** Click on "Per Diem Rates," then select "2007" for the rates effective for the period October 1, 2006 through December 31, 2006. See IRS Pub 463, *Travel, Entertainment, Gift, and Car Expenses*, for additional information on this topic.

HEROES EARNED RETIREMENT OPPORTUNITIES ACT (HERO ACT)

Congress enacted the Heroes Earned Retirement Opportunities Act (HERO Act),[66] signed into law by the president on May 29, 2006,[67] to allow service members to save additional money for retirement. Before the passage of this legislation, military service members receiving nontaxable combat zone pay were prohibited from including this compensation when determining the amount of any allowable IRA contribution. The HERO Act now permits combat zone pay to be treated as compensation for purposes of the IRA compensation limitation rules under §§219(b)(1)(B) and 219(c).[68] This act also applies to Roth IRA contributions.

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65. IRC §274(n)(3)(A)
66. H.R. 1499
67. P.L. 109-227
68. IRC §219(f)(7)

IRC §112(c)(2) describes a combat zone as any region the president designates as an area in which U.S Armed Forces are engaged in combat. Combat zones currently include Afghanistan; Pakistan; the Arabian Peninsula Areas, including the Persian Gulf, Red Sea, Gulfs of Oman and Aden; and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

The provisions of this act **apply retroactively to 2004**. Taxpayers who received combat pay for any tax year ending after December 31, 2003, and before May 29, 2006, have a three-year window to make IRA contributions for those years. This means qualified service members who file on a calendar-year basis have until May 28, 2009, to make contributions for tax years 2004 and 2005. For income tax purposes, contributions are treated as if they were made on the last day of each applicable year.

Taxpayers who qualify to make retroactive contributions are still allowed a refund, regardless of whether an affected tax year is closed by the statute of limitations, as long as any claim for refund is filed within one year of making a contribution.[69]

Example 20. Nic Wilson received nontaxable combat pay in 2004 and 2005. He plans to contribute $4,000 to his traditional IRA on May 28, 2009. Two thousand of this contribution is designated to 2004 and $2,000 to 2005.

Nic may file amended returns to claim refunds for both these tax years through May 28, 2010. Even though the statute of limitations expired for both 2004 and 2005, Nic is still eligible for refunds for these years since he will file his claims before May 28, 2010, or one year from the date he makes his retroactive contributions.

Observation. A taxpayer who qualifies for retroactive contributions will benefit from consulting with a tax practitioner prior to making any contribution to determine which type of IRA contribution — traditional or Roth — would be the most advantageous. Since combat pay is nontaxable, a traditional IRA may not be the best option.

There are many other tax consequences to consider. Since a traditional IRA contribution lowers adjusted gross income (AGI), it affects many other tax benefits, such as the earned income tax credit, retirement saver's credit, education credits, the percentage applied for the day care credit, as well as Schedule A medical and miscellaneous business expenses.

In states that piggyback off federal AGI, a traditional IRA contribution also lowers state income tax. However, each state must enact legislation to allow for a refund in a closed tax year in order for taxpayers to benefit from the full three-year window for contributions.

DIRECT DEPOSIT OPTIONS EXPAND FOR REFUNDS

Effective January 2007, individual filers can **designate up to three separate accounts** in which to receive direct deposit income tax refunds. Taxpayers who opt to split their refunds between two or three accounts must provide account information on **Form 8888, *Direct Deposit of Refund.***

Taxpayers who choose to direct deposit into a **single account** may continue to do so on the appropriate line of the Form 1040 series. Taxpayers filing Form 8379, *Injured Spouse Allocation*, are **not eligible** to file Form 8888. These taxpayers may not have their refund deposited into more than one account.

The IRS issued over 100 million refund checks last year and over 52 million of these were directly deposited into taxpayer's accounts. The average refund was $2,171. The IRS hopes this expanded direct deposit program will encourage taxpayers to set aside a portion of their refunds for savings.

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69. The HERO Act, P.L. 109-227, § 2(c)(2)(A), May 29, 2006

> **Observation.** Although this program expansion is intended to facilitate savings, the multiple account option can also provide a harmonious alternative for splitting refunds between joint filers (other than those filing as injured spouses). This can help both those who are headed to divorce court and those who wish to avoid it.

Taxpayers can split their refunds among checking, savings or other types of accounts at banks or other financial institutions, such as mutual funds, brokerage firms, or credit unions. Other types of accounts may include individual retirement accounts (IRAs), health savings accounts (HSAs), Archer medical savings accounts (MSAs), or Coverdell education savings accounts (ESAs).

> **Caution**. Some financial institutions will not allow a joint refund to be deposited into an individual account. If a direct deposit is rejected, the IRS will issue a paper check by mail.

CHANGES IN REFUND AMOUNTS

Any change in the amount refunded due to a math error or past-due federal tax generally will affect deposits made to multiple accounts in reverse order. If a refund is increased, the excess will be deposited into the last account listed, i.e., the third account for a three-way split, or the second account for a two-way split. Decreases are adjusted likewise, with the decreased amount deducted from the last account listed first, and then the next account in descending order (if necessary).

However, other past-due amounts subject to offset by the Treasury Department's Financial Management Service (FMS) will be deducted first from the account with the lowest routing number. Any remaining amount due will be deducted from the account with the next lowest routing number and then from the account with the highest routing number.

DIRECT DEPOSIT TO AN IRA

Extra steps must be taken when depositing a refund into an IRA. The trustee must be notified for which year the deposit is to be credited. Contributions designated for 2006 must be made by April 16, 2007 (or the unextended due date of the taxpayer's return). If a designated refund is not deposited into an IRA by the due date, the taxpayer is required to file an amended return correcting the amount of the IRA contribution.

Example 21. Newlyweds Ted and Sue Bird filed their 2006 joint return on March 30, 2007. They attached Form 8888 to their return, requesting that their refund of $1842 be split among three accounts, as follows:

Form **8888** — Department of the Treasury, Internal Revenue Service

Direct Deposit of Refund

▶ See instructions below and on back.

▶ Attach to Form 1040, Form 1040A, Form 1040EZ, Form 1040NR, Form 1040NR-EZ, Form 1040-SS, or Form 1040-PR.

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Name(s) shown on return: **Ted & Sue Bird** — Your social security number: 123 45 6790

1a	Amount to be deposited in first account	1a	342
b	Routing number 121234567 ▶c ☑ Checking ☐ Savings		
d	Account number 342423		
2a	Amount to be deposited in second account	2a	500
b	Routing number 322345678 ▶c ☐ Checking ☑ Savings		
d	Account number 61177		
3a	Amount to be deposited in third account	3a	1,000
b	Routing number 250250025 ▶c ☐ Checking ☑ Savings		
d	Account number 3006247		
4	**Total amount to be directly deposited.** Add lines 1a, 2a, and 3a. The total must equal the amount shown on Form 1040, line 74a; Form 1040A, line 45a; Form 1040EZ, line 12a; Form 1040NR, line 72a; Form 1040NR-EZ, line 24a; Form 1040-SS, line 12a; or Form 1040-PR, line 12a	4	1,842

Account Number	Routing Transit No.	Type of Account	Amount Deposited
1	12-1234567	Checking	$ 342
2	32-2345678	Savings	500
3	25-0250025	Savings (2006 IRA)	1,000

However, the IRS rejected the dependency allowance for Sue since she failed to change her social security card to reflect her married name. Ted also had a lien against his refund for back due child support. The amount of the Bird's refund was reduced by the following amounts:

Math error	$924
Child support offset	400

These adjustments resulted in the following corrected deposits, which were made to the Bird's accounts on April 14, 2007:

Account	Adjustment	Corrected Deposit
1	($342)	$ 0
2	0	500
3	(982)	18

Account 1 had the lowest routing transit number (RTN), so $342 of the child support obligation was debited from this account first, and the $58 remaining amount ($400 – $342) was debited from Account 3, the account with the second lowest RTN. Since this satisfied the $400 child support obligation, Account 2 was unaffected.

The $924 math error was applied entirely against Account 3. However, this left Account 3 with a deposit of only $18, instead of the original $1,000 that the Birds had requested. Since Account 3 was intended to be a 2006 IRA contribution, the Birds will have to either deposit an additional $982 into the IRA before April 16, 2007 or amend their 2006 return.

Note. Because of the ordering rules for changes in refund amounts, it is advisable to list an IRA as the first account (or first and second for married filers). This may prevent the need to correct any contribution amounts in the event a refund is changed.

TELEPHONE EXCISE TAX REFUND

Originally established in 1898 as a luxury tax to finance the Spanish-American War, the 3% federal excise tax on long-distance telephone services has raised more than $90 billion dollars since its inception. This tax was imposed on taxpayers but collected and remitted to the IRS by telephone service providers. However, on May 25, 2006, the U.S. Treasury Department conceded the dispute over the legality of this tax after losing in five circuit courts of appeal.

Federal judges ruled the excise tax on long-distance services was a violation of IRC §4252(b)(1) since it imposed a tax on "time-only" service charges instead of "time and distance" charges as required by law. Phone companies were ordered to cease collecting the excise tax for long distance services billed after July 31, 2006, although customers may refuse to pay the tax on any services billed after May 25, 2006. The excise tax for local services is still in effect, although Treasury Secretary John Snow called on Congress to eliminate it as well.[70]

70. Treasury Department News Release JS-4287, *Treasury Announced End to Long-Distance Telephone Excise Tax*, May 25, 2006

The IRS will grant refunds to **all eligible individuals, businesses, and nonprofit organizations;** however, the refund is limited to a 3-year look-back period due to the statute of limitations. Eligible taxpayers are those who paid taxes on **long-distance telephone services on landlines, cell phones, or Voice over Internet Protocol (VoIP) services billed after February 28, 2003 and before August 1, 2006.**[71]

All refund requests must be made on taxpayers' 2006 federal income tax returns. A special **short Form 1040EZ-T** will be available for taxpayers who wish to apply for the refund but are not otherwise required to file a return. **Individuals** can choose from two methods to claim the refund: the simplified, standard method and the actual expense method. At the time this publication went to press, the IRS was working on a simplified estimation method for businesses and non-profit organizations.

The standard refund amount may be claimed as a line item on an individual's 2006 federal income tax return. Standard refunds are paid according to the following schedule, based on the number of exemptions claimed on the taxpayer's **2006** return:

Number of Exemptions	Refund Amount
1	$30
2	40
3	50
4 or more	60

Observation. With the elimination of the marriage penalty, it may be beneficial for some married taxpayers to file separately to receive a larger credit. However, all consequences of filing a separate return should be carefully considered before taking this action.

The **actual expense method** requires taxpayers to calculate the amount of tax actually paid during the refund period. Only the amount of the 30% **federal excise tax** charged on telephone services **other than local service** qualifies, although the IRS is also refunding taxes collected on telephone services under plans that did not differentiate between long distance and local calls. Federal access charges and state and local taxes and charges **do not** qualify.

To substantiate their actual refund claims, taxpayers will need to produce their billing records for the 41-month refund period. Telephone companies may charge a fee to provide this information. Requests for refunds of actual taxes paid are filed on **Form 8913** and attached to the taxpayer's 2006 return. **The IRS will pay interest in addition to actual expense claims;** interest is already computed in the standard refund amounts shown above.

The IRS expected to collect more than $25 billion between 2006 and 2010 on this tax. Instead, economists at the U.S. Department of the Treasury estimate the IRS will be issuing approximately $10 billion in refunds.[72] Refunds will be issued as part of the taxpayer's income tax refund and accordingly it will reduce any amount of tax owed or increase any refund amount due on the taxpayer's 2006 federal income tax return.

Note. Business taxpayers must calculate the actual 3% excise tax collected after February 28, 2003. This calculation could be a time-consuming and expensive chore for business taxpayers.

71. IRS News Release IR-2006-137, *IRS Announces Standard Amounts for Telephone Tax* Refunds, August 31, 2006; and *Telephone Tax Refund Questions and Answers* at www.irs.gov/newsroom/article/0,,id=161506,00.html.

72. *Telephone Tax Refund Questions and Answers* at www.irs.gov/newsroom/article/0,,id=161506,00.html.