KEY PROVISIONS IN THE TAX RELIEF AND HEALTH CARE ACT OF 2006

Both the House (on December 8, 2006) and the Senate (on December 9, 2006) passed by large margins, the Tax Relief and Health Care Act of 2006. What began as a protracted struggle to reinstate tax breaks which expired at the end of 2005 evolved into a multifaceted bill which extends (and in some cases modifies) many important provisions - such as the research credit, employment credits and the option to deduct state and local general sales taxes - and includes a number of important new provisions. The latter include liberalized rules for Health Savings Accounts, a "fix" of sorts for those who exercised incentive stock options and wound up with costly AMT problems, and a one-year itemized deduction for private mortgage insurance on qualified personal residences.

This Hot Topic reviews the Act's key changes and explains how they affect individuals and businesses.

- **Research Credit Extended for Two Years and Modified for 2007**

  The research expense credit (claimed on Form 6765) equals the sum of:

  (1) 20% of any excess of qualified research expenses for the tax year over a base amount, (unless the taxpayer elects the alternative incremental credit, which would then replace this item).

  (2) The "university basic research credit," i.e., 20% of the basic research payments determined under the Code.

  (3) 20% of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.

  The base amount is a fixed-base percentage of taxpayer's average annual gross receipts from a U.S. trade or business, net of returns and allowances, for the four tax years before the credit year, and can't be less than 50% of the year's qualified research expenses. The fixed base percentage for a non-startup company which isn't using the alternative incremental credit is the percentage (not exceeding 16%) that taxpayer's total qualified research expenses is of total gross receipts for tax years beginning after 1983 and before 1989. Special rules apply to a "startup company" that has qualified research expenses.

  Taxpayers are allowed to elect an alternative incremental research credit regime in lieu of the regular research credit. If elected, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable) and the credit rate likewise is reduced. The pre-Act law

credit rates were: 2.65%, 3.2% and 3.75%.

Under pre-Act law, the research credit expired for amounts paid or incurred after 2005.

New law. The research credit is retroactively reinstated and made available for amounts paid or incurred after December 31, 2005, and before January 1, 2008. In addition, the credit for portions of tax years which are in 2007 is modified by: (1) increasing the rates of the alternative incremental credit, as amended; and (2) creating a new alternative simplified credit that does not use a gross receipts factor.

- **Increased rates for alternative incremental credit.**

  For tax years ending after December 31, 2006, the Act provides that under the alternative credit regime an increased credit rate of:

  < 3.0% (instead of the pre-2007 rate of 2.65%) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the taxpayer's average gross receipts for the four preceding tax years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5%.

  < 4.0% (instead of the pre-2007 rate of 3.3%) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5% but do not exceed a base amount computed by using a fixed-base percentage of 2%.

  < 5.0% (instead of the pre-2007 rate of 3.75%) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%.

  Allowance of the Act's higher rates are prorated for a tax year which straddles December 31, 2007 (the termination date for the research credit).

- **New alternative simplified research credit.**

  For tax years ending after December 31, 2006, the Act adds a new “alternative simplified credit” which a taxpayer can elect (in lieu of the 20% credit otherwise determined) equal to 12% of the excess of the qualified research expenses for the tax year over 50% of the average qualified research expenses for the three tax years preceding the tax year for which the credit is being determined. If a taxpayer has no qualified research expenses in any one of the three preceding tax years, the alternative simplified research credit is 6% of the qualified research expenses for the tax year for which the credit is being determined.

  The election of the alternative simplified credit applies to the tax year for which it is made and all succeeding tax years unless revoked with IRS's consent. The election cannot be made for any tax year to which an election of

the alternative incremental credit applies. An election of the alternative incremental credit which applies to a the tax year that includes January 1, 2007, will be treated as revoked with IRS's consent (for that and later years) if the taxpayer elects the alternative simplified credit for the year. However, the alternative incremental credit and the alternative simplified credit can apply to a tax year that straddles December 31, 2007.

Allowance of the alternative simplified credit is prorated for a tax year which straddles December 31, 2007 (the termination date for the research credit).

- **Employment Credits Extended and Modified**

The work opportunity tax credit (WOTC) allows employers who hire members of certain target groups to get a credit against income tax (use Form 5884) of a percentage of first-year wages up to $6,000 per employee ($3,000 for qualified summer youth employees). The pre-Act target groups are: Qualified IV-A recipients (qualified recipients of aid to families with dependent children or successor program), qualified veterans, qualified ex-felons, high-risk youths, vocational rehabilitation referrals, qualified summer youth employees, qualified food stamp recipients and qualified SSI recipients. Under pre-Act law, the WOTC was not available for wages paid or incurred to eligible individuals who began work for the employer after December 31, 2005.

The pre-Act law percentage of qualifying wages is 40%, for a maximum credit of $2,400 ($1,200 for summer youth employees). The minimum employment period is 120 hours, but the credit is only 25% of wages paid to an employee who works less than 400 hours. In either case, more than half of the employee's wages must be for services in the employer's trade or business.

Wages, for purposes of determining eligible wages for the WOTC, is defined similarly to wages for purposes of the welfare-to-work credit, except the WOTC doesn't include some non-taxable fringe benefits the welfare-to-work credit includes (see discussion below). Also, under pre-Act law, for agricultural or railroad employees, wages of up to $6,000 per year, for *all* agricultural employees, and $500 per month, for *all* railroad employees, were considered unemployment insurance wages, and, so “wages” for purposes of the credit.

To be eligible for the credit, a new employee must be certified as a member of a target group by a State Employment Security Agency (SESA). The employer can either get the certification by the day the prospective employee begins work or complete a pre-screening notice for the employee by the day he is offered employment, and submit it to the SESA as part of a request for certification within 21 days after the employee begins work.

Under pre-Act law, the welfare-to-work tax credit was available for wages paid or incurred to eligible individuals who began work for the employer before January 1, 2006. Under this credit, employers who hired long-term family assistance recipients could claim a credit for 35% of up-to-$10,000 of qualified first-year wages (maximum credit: $3,500) and 50% of up-to-$10,000 of qualified second-year wages (maximum credit: $5,000).

New law. The work opportunity tax credit (WOTC) is retroactively reinstated and made available for wages paid or incurred to eligible individuals who begin work for the employer after December 31, 2005, and before January 1, 2008.

Additionally, the welfare-to-work tax credit is retroactively reinstated and made available for wages paid or incurred to eligible individuals who begin work for the employer after December 31, 2005, and before January 1, 2008.

- The Act also makes these changes:

  (1) the WOTC is combined with the welfare-to-work credit, for wages paid or incurred for individuals who begin work for the employer after December 31, 2006;

  (2) eligibility for the WOTC is expanded by raising the age ceiling for food stamp recipients from 25 to 40;

  (3) the WOTC family income restrictions for ex-felons (i.e., no more than 70% of BLS lower living standard) are eliminated; and,

  (4) the filing deadline for a pre-screening notice (on Form 8850) is extended from 21 days to 28.

- **New law consolidation of welfare-to-work credit and WOTC.**

  For individuals who begin work for the employer after December 31, 2006, the separate welfare-to-work credit under Code Sec. 51A is repealed. However, "long-term family assistance recipients" under the welfare-to-work credit are designated as a targeted group for purposes of the WOTC.

  For employment of a long-term family assistance recipient:

  < the amount of the WOTC for the tax year will include 50% of the "qualified-second year wages" (defined below) for that year, and

  < instead of applying the $6,000 limit that generally applies to qualified-first year wages, the amount of qualified first-year wages, and the amount of "qualified-second year wages," which may be taken into account for the recipient won't be allowed to exceed $10,000 per year.

  "Qualified second-year wages" are qualified wages that (1) are paid to a long-term family assistance recipient, and (2) are attributable to service rendered during the 1-year period beginning on the day after the last day of the 1-year period beginning with the day the individual begins work for the employer.

  Thus, for long-term family assistance recipients, the maximum credit for qualified first-year wages will be $4,000 (i.e., 40% ×× $10,000) and the maximum credit with respect to "qualified second-year wages" will be $5,000 (i.e., 50% ×× $10,000).

  A long-term family assistance recipient is an individual certified by the

designated local agency as being a member of a family receiving assistance under a IV-A program for at least the 18-month period ending on the hiring date, or for 18 months beginning after August 5, '97, and hired within 2 years after the end of the earliest 18 month period, or as being a member of a family that ceased to be eligible for assistance because of a limitation imposed by federal or state law on the maximum period of available assistance, and hired not more than 2 years after benefits ceased.

The Act also modifies the WOTC rule for farm and labor wages, as follows: (1) if a long-term family assistance recipient is an agricultural employee, wages of up to $10,000 per year will be considered unemployment insurance wages for which a WOTC will be allowed; and (2) if a long-term family assistance recipient is a railroad employee, wages of up to $833.33 per month will be considered unemployment insurance wages for which a WOTC will be allowed.

- **Credit for Qualified Zone Academy Bonds Extended for Two Years**

  Eligible taxpayers who hold qualified zone academy bonds (QZABs) are entitled to a tax credit under the Code. Under the new law, up to $400 million of QZABs may be issued annually in calendar years 2006 and 2007. Under pre-Act law, a total of $400 million of QZABs were authorized to be issued in calendar years 1998 through 2005. The Act also adds special rules relating to expenditures and arbitrage and creates a reporting requirement for QZAB issuers.

  - **How credit works**. Banks, insurance companies, and other corporations actively engaged in the lending business which hold QZABs are entitled to a nonrefundable tax credit (claimed on Form 8860) equal to a credit rate published daily by Bureau of Public Debt on its Internet site multiplied by the face amount of the bonds held on each credit allowance date (the day before each annual anniversary of the bonds' issuance). A holder who cannot use all or a portion of the credit to reduce its tax liability is allowed a deduction for the unused portion of the credit for the tax year which includes the credit allowance date. QZABs are certain state or local government bonds subject to an overall $400 million national annual limitation, whose proceeds are used for certain purposes by public schools located in an empowerment zone or enterprise community, or that have a certain percentage of low-income students, to which private sources contribute certain amounts of goods or services.

    The credit is includible in gross income (without regard to the tax liability limitation on the credit). Where QZABs pay stated interest or are issued at a discount, the interest or discount also is taxable.

- **First-Time Home Buyer Credit for District of Columbia Extended for Two Years**

  The first-time Home Buyer credit for the District of Columbia (DC) is retroactively reinstated and made available for eligible property purchased after December 31, 2005, and before January 1, 2008. Under pre-Act law, the credit was not available for property purchased after December 31, 2005.

- **How DC first-time Home Buyer credit works.**

  An individual who hasn't had an ownership interest in a principal residence in the District of Columbia (and, if married, whose spouse hasn't had such an interest) in the one-year period before acquiring a principal residence in the District of Columbia is permitted a one-time only nonrefundable personal tax credit (use Form 8859) of up to $5,000 of the acquired residence's purchase price. The credit phases out ratably between modified AGI (AGI increased by the foreign earned income, possessions, and Puerto Rico exclusions) between $70,000 and $90,000 ($110,000 and $130,000 for joint filers). The maximum credit for a married individual filing separately is $2,500. The basis of the residence is reduced by the amount of the credit claimed.

- **Other DC tax breaks extended for two years**

The Act extends the designation of the DC Zone (the District of Columbia Enterprise Zone) for two years (through December 31, 2007). Under pre-Act law, the designation of the DC Zone ended on December 31, 2005. Thus, the Act extends for two years: (1) the additional $35,000 of Code Sec. 179 expensing allowed to DC Zone businesses under the Code (and the break allowing only 50% of expensing eligible property to be counted for purposes of the investment based phaseout of expensing); and (2) the 20% wage credit under the Code for eligible DC Zone employers. The Act also:

- Extends DC tax-exempt financing authority through 2007; under pre-Act law, the ability to issue such financing ended on December 31, 2005.

- Extends for two years (through 2012) the zero percent capital gains rate applicable to capital gains from the sale of certain qualified DC Zone assets held for more than five years; under pre-Act law, the zero percent rate didn't apply to periods after December 31, 2010.

- **New Markets Tax Credit Extended for One Year and Modified**

The Act extends the Code Sec. 45D new markets tax for one additional year (through the end of 2008), permitting a $3.5 billion maximum annual amount of qualified equity investments. Under pre-Act law, 2007 was the last year for which there was a maximum annual amount of qualifying equity investments.

- **Credit basics**. A “new markets tax credit” (claimed on Form 8874) applies for qualified equity investments to acquire stock in a community development entity (CDE). A CDE is any domestic corporation or partnership (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities through representation on governing or advisory boards of the CDE, and (3) is certified by the Treasury Department as an eligible CDE.

  In general, the new markets tax credit is: (a) 5% for the year in which the equity interest is purchased from the CDE and for the first two anniversary dates after the purchase (for a total credit of 15%), *plus* (b) 6% on each

anniversary date thereafter for the following four years (for a total of 24%).

- **Optional Itemized Deduction for Sales and Use Tax Extended for Two Years**

  The optional itemized deduction for state and local sales and use tax which applied only for tax years beginning in 2004 and 2005 under pre-Act law is reinstated and made available for tax years beginning after 2005 and before 2008.

  - **How the deduction works.** Taxpayers may elect (on Schedule A of Form 1040) to deduct state and local *general sales and use* taxes instead of state and local *income* taxes. With limited exceptions, a sales or use tax is general if imposed at one rate with respect to the retail sale of a broad range of classes of items.

    Electing taxpayers may deduct either:

    (1) the amount of state and local general sales taxes paid, by accumulating receipts; or

    (2) the amount determined under IRS tables (see below), plus the actual amount of sales taxes paid on motor vehicles, boats and other IRS-specified items (e.g., aircraft, homes).

    The IRS tables provide an amount of sales taxes paid based on the taxpayer's state of residence, total available income and number of exemptions. Taxpayers living in more than one state during the year must prorate the table amounts based on the number of days lived in each state. For married taxpayers, use of the tables depends on whether they file jointly or separately, and whether they live in the same state.

    The sales tax deduction is particularly beneficial to taxpayers in states which impose a sales tax but not an income tax, i.e., Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. But it may also benefit any taxpayer who paid more in sales taxes than income taxes - e.g., taxpayers who bought a new car or claimed state income tax credits.

    The elective sales tax deduction doesn't apply to sales taxes paid on items used in a taxpayer's trade or business.

    If the election is not made, state and local sales or use taxes are deductible only to the following extent: State or local sales or use taxes paid or incurred in connection with the acquisition or disposition of property and taxes on the transfer of property (e.g., securities, real estate), aren't deductible (buyer treats them as part of the cost, seller as a reduction in the amount realized). Other sales taxes are deductible only if paid or incurred in a trade or business or for the production of income.

- **Above-the-Line Deduction for Expenses of Educators Extended for Two Years**

The above-the-line deduction for expenses of educators is reinstated and made available for tax years beginning after 2005 and before 2008. Under pre-Act law, the deduction expired for tax years beginning after 2005.

- ***How the deduction works.*** An eligible educator - a grade K through 12 teacher, instructor, counselor, principal or aide in a school for at least 900 hours during a school year - may claim an "above the line deduction" (i.e., an adjustment to gross income to arrive at adjusted gross income) for up to $250 of trade or business expenses paid or incurred for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment and supplementary materials used in the classroom.

■ Above-the-Line Deduction for Eligible Individual's Higher-Education Expenses Extended for Two Years

The above-the-line deduction for higher education expenses is reinstated and made available for tax years beginning after 2005 and before 2008. Under pre-Act law, the deduction expired for tax years beginning after 2005.

- ***How the deduction works***. Eligible individuals may deduct higher education expenses - i.e., "qualified tuition and related expenses" of the taxpayer, his spouse or dependents - as an adjustment to gross income to arrive at adjusted gross income (AGI). The deduction may not exceed dollar limits ($2,000 or $4,000) based on modified AGI and phased out above certain AGI levels.

  Modified AGI is AGI determined without regard to the higher-education expense, the U.S. production activities deduction or the exclusions for foreign, possessions and Puerto Rico income.

  The deduction for higher-education expenses is allowed for a tax year only to the extent the qualified tuition and related expenses are for enrollment at a higher education institution during that year, except the deduction is allowed for expenses paid during a tax year if the expenses are in connection with an academic term beginning during that year or during the first 3 months of the next year.

  The higher-education expense deduction isn't allowed:

  < unless the taxpayer includes on his tax return for the relevant year, the name and TIN of the individual for whom the higher education expenses were paid,

  < for any expense for which a deduction is allowed to the taxpayer under any other provisions of the Code,

  < for a tax year with respect to an individual's qualified tuition and related expenses if he or any other person elected to claim a Hope credit or Lifetime Learning credit with respect to that individual for that year.

Higher-education expense deductions may not be claimed by a taxpayer who: files separately for the tax year; may be claimed as a dependent on another's return; or is a nonresident alien for any part of the tax year, unless so treated under a Code Sec. 6013(g) or Code Sec. 6013(h) election (to treat a spouse as a resident alien) by a U.S. citizen or resident with a nonresident alien spouse.

For purposes of the deduction, higher education expenses consist of qualified tuition and related expenses, defined the same way as for Hope and Lifetime Learning Credit purposes, but reduced by the amount of the expenses which are taken into account in determining amounts excluded under the Code sections for: interest on bonds used to pay for higher education expenses, distributions from qualified tuition plans, but limited to the excludible earnings from such plans and full amount of distributions from Coverdell education savings accounts. Qualified tuition and related expenses also are reduced by certain excludible scholarships and other payments.

- **Election to Include Combat Pay as Earned Income for EITC Purposes Extended for Two Years**

  The election to treat excluded combat pay as earned income for earned income tax credit (EITC) purposes is reinstated and made available for tax years beginning after 2005 and before 2008. Under prior law, the election expired for tax years beginning after 2005.

  - ***How the election works.*** A taxpayer may elect to treat combat pay that is excluded from gross income as earned income for EITC purposes.

- **Enhanced Deduction for C Corporation Computer Donations Extended for Two Years and Broadened**

  The enhanced deduction for computer contributions by C corporations is reinstated and made available for tax years beginning after 2005 and before 2008. Under pre-Act law, the deduction expired for tax years beginning after 2005. The Act also allows equipment "assembled by" the donor to qualify for the enhanced deduction, effective for tax years beginning after 2005.

  - ***How the deduction works.*** A C corporation may claim an enhanced deduction equal to the lesser of (a) basis plus half of the property's appreciation, or (b) twice the property's basis, for, among other items, contributions of computer technology or equipment (software, computer or peripheral equipment and fiber optic cable) to schools or libraries for use in the U.S. for educational purposes which is related to the donee's purpose or function. This applies only if: the contribution is made no later than three years after the date the taxpayer acquires or substantially completes construction (or, under the Act, assembly) of the property; the donor or the donee is the property's original user; and other specified requirements are met. Certain property donated after reacquisition by a computer manufacturer (or, under the Act, assembler) also qualifies.

- **Enhanced Deduction for C Corporation Scientific Equipment Broadened**

A C corporation also may claim an enhanced deduction equal to the lesser of (a) basis plus half of the property's appreciation, or (b) twice the property's basis, for contributions of scientific equipment or apparatus to a higher education institution or a tax-exempt organization (but not a private foundation) organized and operated primarily to conduct scientific research. Under pre-Act law, this applies only: if the taxpayer constructed the property and the contribution is made no later than two years after the date the property was substantially completed; if the donee is the original user of the property; and other specified requirements are met.

New law. For tax years beginning after 2005, the enhanced deduction for C corporation donations of scientific equipment also applies to qualifying equipment assembled by the corporation.

- **Accelerated Write-off for Qualified Leasehold Property and Qualified Restaurant Improvements Extended for Two Years**

The Act extends for two years the 15-year straight line write-off (instead of straight-line 39 year write-off) for qualified leasehold improvements and qualified restaurant improvements. The accelerated write-off applies to property placed in service after December 31, 2005, and before January 1, 2008. Under pre-Act law, the accelerated write-off wasn't available for otherwise eligible property placed in service after 2005.

In general, qualified leasehold improvement property is any improvement to an interior portion of a building which meets the requirements in the Code. However, if a lessor makes an improvement which qualifies as qualified leasehold improvement property, it can't be qualified leasehold improvement property to any subsequent owner of the improvement, subject to exceptions for non-recognition and death transfers.

Qualified restaurant property is any improvement to a building if the improvement is placed in service more than three years after the date the building was first placed in service and more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals.

- **Net Income Limit on Percentage Depletion From Marginal Oil and Gas Wells Suspended Through 2007**

When calculating percentage depletion deductions for an oil or gas property, the amount deducted can't (among other restrictions) exceed 100% of the taxable income from that property in any year. Under the Act, this 100%-of-taxable-income limit doesn't apply to domestic oil and gas production from marginal-production properties during tax years beginning after December 31, 2005, and before January 1, 2008. Under pre-Act law, the suspension of the 100%-of-taxable-income limit for marginal properties did not apply for tax years beginning after December 31, 2005.

- **Expensing of Remediation Costs Extended for Two Years and Expanded**

The Act extends for two years the election to treat qualified environmental remediation expenses which would otherwise be chargeable to capital account as deductible in the year paid or incurred. The election will be available for expenses paid or incurred after December 31, 2005, and before January 1, 2008. Under pre-Act law, the election generally was not available for expenses paid or incurred after December 31, 2005. To be deductible currently, a qualified environmental remediation expense must be paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. Special rules applied to expenses for depreciable property. Expensed qualified environmental remediation costs are subject to recapture upon the sale or other disposition of the property.

For expenses paid or incurred after 2005, the Act also permits petroleum products to be treated as hazardous substances, the cleanup of which can be a qualified remediation expense if the Code requirements are otherwise met.

- **Other Extended Provisions**

The Act extends and/or modifies a number of other relatively specialized tax provisions and makes some of them permanent. Here is a summary of these provisions:

- The Act creates a temporary, two year credit for possessions corporations operating in American Samoa. The credit is generally based on the amount of wages paid in American Samoa and depreciation deductions with respect to property located there, and is effective for the first two tax years beginning after December 31, 2005, and before January 1, 2008. Under pre-Act law, certain domestic corporations operating in American Samoa were eligible for a possessions tax credit, which offset their U.S. tax liability on income earned in American Samoa from active business operations, sales of assets used in a business or certain investments in American Samoa. However, the credit expired on December 31, 2005

- The Act provides that no new contributions may be made to Archer Medical Savings Accounts (Archer MSAs) after December 31, 2007, except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. Under pre-Act law, the cutoff date for such new contributions was December 31, 2005. In general, Archer MSAs allow favorable tax treatment of money saved for medical expenses by certain taxpayers covered by high-deductible health plans. Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA aren't currently taxed. Distributions for medical expenses aren't taxed, but those used for other purposes are taxed and are subject to a 15% penalty tax unless made after age 65, death or disability.

- The Act extends for one year through December 31, 2007, provisions proving for parity in mental health benefits under ERISA, the Public Health Service Act

(PHSA) and the Code, effective on the date of enactment. Group health plans providing both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits which are not also imposed on substantially all medical and surgical benefits. The Code imposes an excise tax on group health plans which fail to meet this rule. Under pre-Act law, these provisions were scheduled to expire after December 31, 2006.

- **Opportunity for Fiscal Year Taxpayers to Make Certain Revived Elections**

The Act gives fiscal year taxpayers with tax years ending in 2006, but before the enactment date, an opportunity to change elections, already made on their originally filed returns, to take into account the extension of the provisions which expired at the end of 2005:

- The Act provides that an election of the alternative incremental credit in lieu of the regular research credit or election of reduced research expense credit for a tax year ending after 2005 and before the enactment date, is treated as having been timely made for the tax year if it is made not later than the later of April 15, 2007, or such time as IRS may specify. The election must be made in the manner prescribed by IRS.

- The Act provides that, except as otherwise provided by IRS, a similar rule applies for elections under any provisions which had expired and were revived by the Act.

- **Code Sec. 199 Deduction OK'd for Puerto Rico Activities for Two Years**

The domestic production activities deduction is available only if, among other conditions, the taxpayer has domestic production gross receipts from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.; (2) any sale, exchange, etc., of qualified films produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.; (4) construction activities performed in the U.S.; or (5) engineering or architectural services performed in the U.S. for construction projects located in the U.S.

Under pre-Act law, the U.S. did not include Puerto Rico.

New law. For the first two tax years of the taxpayer beginning after December 31, 2005, and before January 1, 2008, a taxpayer may treat Puerto Rico as part of the U.S. for Code Sec. 199 purposes, but only if all of its gross receipts from sources within Puerto Rico are currently taxable for U.S. Federal income tax purposes. Consequently, a controlled foreign corporation is not eligible for the Code Sec. 199 deduction made available by the Act's change. In addition, a taxpayer may to take into account wages paid to bona fide residents of Puerto Rico for purposes of calculating the 50% wage limitation, without regard to any Code Sec. 3401(a)(8) exclusion.

- **Refundable Credit for Unused AMT Credit**

The alternative minimum tax (AMT) applies in a tax year only to the extent it exceeds the taxpayer's regular tax liability for the year. An individual's AMT liability is the excess (if any) of his tentative minimum tax (i.e., AMT before deducting regular tax) over his regular tax, for the year. The AMT is imposed on alternative minimum taxable income (AMTI) - taxable income increased by certain items (exclusion preferences) and adjusted by treating certain items in a manner which negates the deferral of income resulting from their regular tax treatment (deferral adjustments). To the extent an individual's AMT liability is caused by deferral adjustments, he may be entitled to carry forward a minimum tax credit to a later year for which his tentative minimum tax is less than his regular tax liability, to reduce his regular tax for that year. The minimum tax credit for a tax year equals the excess, if any, of the adjusted net minimum tax (ANMT) - i.e., the AMT paid for the year reduced by the amount of AMT which would have arisen if the only applicable preferences and adjustments were exclusion preferences, plus certain other amounts - for all earlier tax years which began after 1986, over the minimum tax credits taken in those years.

Under pre-Act law, an individual's minimum tax credit for a tax year was limited to the excess of: (a) his regular tax liability for the tax year to which the credit was being carried, reduced by the sum of his nonrefundable personal credits and business-related income tax credits for the year, over (b) his tentative minimum tax (i.e., AMT before deducting regular tax) for the year. The credit was nonrefundable - i.e., any minimum tax credit in excess of the above-described limitation could not be refunded. However, the “excess” could be carried forward (but not back) indefinitely.

Pre-Act law produced particularly undesirable results for taxpayers who exercised incentive stock options (ISOs) and thus recognized ordinary income for AMTI purposes.

New law. For tax years beginning after the enactment date, the Act provides that if an individual has a “long-term unused minimum tax credit” for any tax year beginning before January 1, 2013, the amount determined under the Code Sec. 53(c) limit on the minimum tax credit for the tax year can't be less than “the AMT refundable credit” amount for that tax year. This credit is subject to a phaseout and is refundable.

> **Observation:** Thus, the minimum tax credit allowable for the tax year is the greater of the AMT refundable credit amount or the amount of the credit otherwise allowable.
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> **Illustration:** Kurt has an AMT refundable credit amount equal to $20,000 for the tax year. His otherwise allowable minimum tax credit for the year (with the Code limitation) is $15,000. Kurt's minimum tax credit for the tax year is $20,000, the amount of the AMT refundable credit amount. Thus, Kurt can reduce his regular tax liability for the tax year by $20,000. Under pre-Act law, his minimum tax credit couldn't exceed $15,000, so he could reduce his regular tax liability by only $15,000.

The "AMT refundable credit amount" is the greater of (1) the lesser of $5,000 or the long-term unused minimum tax credit, or (2) 20% of the long-term unused minimum tax credit.

The "long-term unused minimum tax credit" for any tax year is the portion of the minimum tax credit determined under Code Sec. 53(b) (i.e., the excess of the ANMT for all earlier tax years over the minimum tax credit for those years) attributable to the ANMT for tax years before the third tax year immediately preceding the tax year. For this purpose, credits are treated as allowed under Code Sec. 53(a) on a first-in, first-out (FIFO) basis.

Observation: In other words, the long-term unused minimum tax credit - and so the AMT refundable credit amount - for a tax year doesn't take into account any minimum tax credit for the three immediately preceding tax years. The minimum tax credit amounts for those three years are allowable under the ordinary minimum tax credit rules. But because the "regular" minimum tax credit is nonrefundable, any unused amounts must be carried over to later tax years, rather than refunded.

Observation: The FIFO requirement precludes taxpayers from using their credits from the immediately preceding three tax years before any credits from earlier years, to increase the amount of unused credits that could qualify as the long-term minimum tax credit and, as a result, increase the amount that can be refunded.

- **Phaseout.**

The AMT refundable credit amount is reduced by the percentage reduction in the personal exemption amount for an individual whose adjusted gross income for a tax year exceeds the AGI threshold at which the deduction for personal exemptions phases out. For this purpose, AGI is determined without regard to foreign earned income exclusion for U.S. citizens or residents living abroad, exclusion of income for bona fide residents of American Samoa and exclusion of income of residents of Puerto Rico.

Observation: Under the phaseout of the personal exemption amount, an individual whose AGI for a tax year exceeds an annually-adjusted threshold amount must reduce his personal exemption amount by an applicable percentage (which can't exceed 100%) - 2% for each $2,500 or fraction thereof (2% for each $1,250 or fraction thereof for married individuals filing separately) - by which the individual's AGI exceeds the threshold amount. For 2006, the threshold amounts are: (a) $225,750, for married filing jointly or surviving spouse; (b) $188,150, for head of household; (c) $150,500, for unmarried taxpayers (other than surviving spouse); and (d) $112,875, for marrieds filing separately.

Observation: While the statute itself doesn't apply specifically to the AMT treatment of incentive stock options (ISOs), the legislative history indicates this is the motivation for the refundable credit. Under the regular tax, the grant and exercise of an ISO is generally tax-free if the stock is not disposed of within one year of the option's exercise or within two years of its grant. However, the

exercise of these options (and sometimes their grant) is subject to the AMT (as an adjustments in computing AMTI) at the value of the stock when the option was exercised, with the result that the taxpayer has ordinary income for AMTI purposes. The AMT rules can sometimes result in a particularly harsh effect on employees who are granted ISOs by their companies, and a number of taxpayers have been surprised with enormous AMT bills.

- **Liberalized Rules for Health Savings Accounts (HSAs)**

Eligible individuals may, subject to statutory limits, make deductible contributions to a health savings account (HSA). Employers as well as other persons (e.g., family members) also may contribute on behalf of eligible individuals. Employer contributions generally are treated as employer-provided coverage for medical expenses under an accident or health plan. An HSA may be offered as part of a cafeteria plan. An account holder gets the deduction for contributions to his HSA even if another (e.g., family member) makes the contributions. Employer contributions to an HSA are excludable from income and distributions for qualifying medical expenses are tax-free.

If an individual is claimed as a dependent by another taxpayer for the year, the amount that is allowable as a deduction for an HSA contribution is zero. If an individual for any month is eligible for and enrolled in Medicare, the amount which is allowable as a deduction for an HSA contribution is zero for that month.

Following are some of the more important aspects of HSAs:

- *Eligibility:* HSAs are available to individuals who are covered under a high deductible health plan (HDHP) and are not covered under any other health plan which is not a high deductible plan, unless the other coverage is permitted insurance (see below) or coverage for accidents, disability, dental care, vision care or long-term care. Contributions for eligible individuals who are employees can be made by the employee or employer, or both. An HSA is a tax-exempt entity but is subject to the tax on unrelated business income.

- *High deductible health plan (HDHP).* For 2006, a HDHP is a health plan with an annual deductible of at least $1,050 for individual coverage ($2,100 for family coverage) and maximum out-of-pocket expenses of $5,250 for individual coverage ($10,500 for family coverage). For 2007, a HDHP is a health plan with an annual deductible of at least $1,100 for individual coverage ($2,200 for family coverage) and maximum out-of-pocket expenses of $5,500 for individual coverage ($11,000 for family coverage). However, an HDHP may have a zero preventive care deductible or a preventive care deductible below the minimum annual deductible. Preventive care (e.g., periodic health evaluations in connection with routine exams or routine prenatal and well-child care) does not generally include any service or benefit intended to treat an existing illness, injury, or condition. Family HDHP coverage is a health plan which covers one eligible individual and one other individual (eligible or not).

- *Permitted insurance.* An eligible individual may have insurance covering worker's compensation, torts, and ownership and use of property (e.g., auto insurance); insurance for a specified disease or illness; and insurance

providing a fixed payment for hospitalization. Health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs) constitute “other coverage” which will generally preclude HSA eligibility. However, an exception is provided for limited purpose FSAs and HRAs (those providing only certain benefits (e.g., dental and vision)); suspended HRAs (where the employee elects to forgo reimbursements); FSAs and HRAs imposing annual deductibles, and HRAs providing benefits only after retirement.

- *Limit on contributions.* The maximum annual contribution to an HSA is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. Under pre-Act law, for 2006, the maximum monthly contribution for eligible individuals with self-only coverage is 1/12 of the lesser of (1) the annual deductible of the high deductible plan, or (2) $2,700 ($2,850 for 2007). For eligible individuals with family coverage, the maximum monthly contribution is 1/12 of the lesser of (1) the annual deductible of the high deductible plan, or (2) $5,450 ($5,650 for 2007). In addition, an individual (and the individual's covered spouse) who has attained age 55 before the close of the tax year may make an additional $700 “catch-up” contribution for the tax year beginning in 2006 ($800 in 2007; $900 in 2008; and $1,000 in 2009 and afterwards). There is no requirement that the individual have earnings. Maximum contributions allowed to an HSA for any given year are reduced by any contributions made to an Archer MSA in the same year.

- *Treatment of distributions.* Distributions from HSAs used to pay qualified medical expenses of the account holder and/or spouse and dependents aren't taxable. In general, qualified medical expenses are expenses paid for medical care as defined under the medical expense deduction rules, but only to the extent they're not reimbursed by insurance or otherwise. Qualified medical expenses don't include insurance premiums other than premiums for qualified long-term care insurance, health care continuation coverage (COBRA) for individuals who lost employer-provided coverage and coverage while the eligible individual is receiving unemployment compensation. These expenses must be incurred after the HSA is established. Distributions not used for qualified medical expenses are taxable and are generally subject to a 10% penalty tax.

- *HSA rollovers and carryover of HSA funds.* Amounts in an HSA not distributed by the end of the account holder's tax year may be carried over into the next year. Amounts can be rolled over tax free from an HSA or from an Archer MSA, to an HSA. The rollover must be completed within 60 days after the date on which the account holder receives the amounts from the HSA or Archer MSA. These rollover amounts are not taken into account in determining the annual contribution limits for the recipient HSA. Only one tax-free rollover into an HSA is permitted per one year period. Pre-Act law did not permit rollovers from health FSAs, HRAs or IRAs into HSAs.

- *Comparability rule for employer contributions.* In general, under pre-Act law, all employer contributions to employee HSAs must be the same amount or the same percentage of the HDHP deductible for all employees with the same category of HDHP coverage (self-only, or family). The comparability rules

apply separately to full time, part-time and former employees (except for former employees under COBRA continuation coverage). An employer that fails the comparability rule is subject to a 35% penalty tax. The comparability rules do not apply to HSA contributions made through a cafeteria plan. Instead, the Code Sec. 125 discrimination rules apply. For employer contributions to HSAs after 2006, four categories of HDHP coverage apply (self-only; or family coverage of self plus one, self plus two or self plus three or more).

- *Health FSAs and HSAs.* It was generally understood that the balance remaining in a health FSA as of the end of a plan year had to be forfeited by the employee, but in May, 2005, IRS issued a Notice allowing a grace period, not to exceed two and one-half months immediately following the end of the plan year, during which unused health FSA amounts may be used. However, IRS issued another Notice declaring that an individual participating in a health FSA which allows reimbursements during a grace period is generally not eligible to make contributions to the HSA until the first month following the end of the grace period even if the individual's health FSA has no unused benefits as of the end of the prior plan year.

New law. The Act liberalizes the HSA rules by:

- allowing one-time-only rollovers from health FSAs and HRAs into HSAs;
- providing that FSA coverage during a grace period following the end of the plan year is disregarded coverage for HSA purposes;
- repeals the annual plan deductible limit on HSA contributions;
- provides for earlier indexing of cost-of-living adjustments to HSA figures;
- okays a full contribution for months preceding the month a taxpayer becomes an eligible individual;
- modifies the employer comparable contribution rules; and
- permits one-time rollovers from IRAs to HSAs.

  < **One-time-only rollovers from health FSAs and HRAs into HSAs.** For distributions and contributions on or after the enactment date and before January 1, 2012, the Act allows a limited amount to be distributed from a health FSA or HRA and contributed through a direct transfer to an HSA. The amount can't exceed an amount equal to the lesser of:

  (1) the balance in the health FSA or HRA as of September 21, 2006; or

  (2) the balance the health FSA or HRA as of the date of the distribution.

  Only one distribution with respect to each health FSA or HRA of the individual is allowed. The balance in the health FSA or HRA as of any date is determined on a cash basis (i.e., expenses incurred which have not been

reimbursed as of the date the determination is made are not taken into account). Amounts rolled over to an HSA up to the maximum amount are excludable from gross income and wages for employment tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible.

The one-time rollover is designed to assist taxpayers in transferring from another type of health plan to a high deductible health plan. Thus, if a taxpayer for whom a rollover contribution is made does not remain an eligible individual (for any reason other than death or disability) during a testing period which begins with the month of the contribution and ends on the last day of the 12th month following that month, the rollover contribution is includible in his gross income and is subject to a 10% penalty tax. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual.

Illustration: The balance in Sam's health FSA as of September 21, 2006, is $2,000 and the balance in the account as of January 1, 2008, is $3,000. Under the rollover rule, Sam decides on January 1, 2008, to withdraw $2,000 from the FSA and contribute it to his HSA. He is an eligible individual under the HSA rules on the rollover date. The $2,000 distribution isn't includible in his income, and the contribution to the HSA is not deductible and doesn't count against the annual maximum tax deductible contribution that can be made to the HSA. If Sam ceases to be an eligible individual as of June 1, 2008, the $2,000 contribution amount is included in his gross income and subject to a 10% penalty tax.

Under a modified comparability rule, if an employer allows any employee to make contributions to an HSA from distributions from a health FSA or HRA under the new rollover rule, all employees who are covered under a high deductible plan of the employer must be allowed to make such distributions and contributions. A 35% excise tax applies if the comparability requirement is not met.

- **FSA grace period coverage treated as disregarded coverage for HSA purposes.**

  For tax years beginning after December 31, 2006, coverage under a health FSA during the "grace period" (i.e., the period immediately following the end of a plan year during which unused benefits or contributions remaining may be paid or reimbursed to plan participants for qualified expenses) is disregarded coverage for HSA purposes if:

  (1) the balance in the health FSA at the end of the plan year is zero; or

  (2) in accordance with rules to be prescribed by IRS, the entire remaining balance in the health FSA at the end of the plan year is contributed to an HSA under the Act's new rollover provision (see discussion above).

  Thus, for example, if as of December 31, 2006, a participant's health FSA balance is zero, coverage under the health FSA during the period from

January 1, 2007, until March 15, 2007 (i.e., the grace period) is disregarded in determining if tax deductible contributions can be made to an HSA for that period. Similarly, if the entire balance in an individual's health FSA as of December 31, 2006, is distributed and contributed to an HSA (under the Act's new rollover provision, discussed above), the coverage during the health FSA grace period is disregarded.

Congress intends that IRS will provide guidance with respect to the timing of health FSA distributions contributed to an HSA in order to facilitate such rollovers and the establishment of HSAs in connection with high deductible plans. For example, it is intended that coverage will be disregarded if, before the end of a year, an individual elects high deductible plan coverage and to contribute any remaining FSA balance to an HSA even if the trustee-to-trustee transfer cannot be completed until the following plan year. Similar rules are intended to apply for the Act's new provision allowing amounts from a health FSA or HRA to be contributed to an HSA in order to facilitate such contributions at the beginning of an employee's first year of HSA eligibility.

- **Annual plan deductible limit on HSA contribution is repealed.**

  For tax years beginning after December 31, 2006, the Act modifies the limit on the annual deductible HSA contributions so the maximum deductible contribution is not limited to the annual deductible under the high deductible health plan. Thus, for 2007, the maximum aggregate annual contribution that can be made to an HSA is $2,850 for self-only coverage and $5,650 for family coverage.

- **Earlier indexing of COLA adjustments to HSA figures.**

  For adjustments made for any tax year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31st of the calendar year (rather than August 31st as under pre-Act law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts which are indexed for inflation (i.e., the contribution limits and the high-deductible health plan requirements). IRS is required to publish the adjusted amounts for a year no later than June 1st of the preceding calendar year.

- **Full contribution OK'd for months preceding month that taxpayer is an eligible individual.**

  For tax years beginning after December 31, 2006, individuals who become covered under a high deductible plan in a month other than January may make the full deductible HSA contribution for the year. A taxpayer who is an eligible individual during the last month of a tax year is treated as having been an eligible individual during every month during the tax year for purposes of computing the annual HSA contribution. Thus, he can make contributions for months before he was enrolled in a high deductible health plan. For the months preceding the last month of the tax year that he is treated as an eligible individual solely by reason of the Act's change, the individual is treated as having been enrolled in the same high deductible health plan in

which he was enrolled during the last month of the tax year.

If an individual makes contributions under the liberalized rule and does not remain an eligible individual (except because of disability) during the testing period (which begins with the last month of the tax year and ends on the last day of the 12th month following that month), the amount of the contributions attributable to months preceding the month in which he was an eligible individual which could not have been made but for the liberalization are includible in gross income. The amount is includible for the tax year of the first day during the testing period that the taxpayer is not an eligible individual. A 10% penalty tax also applies to the includible amount.

- **Exception to comparability rule for contributions to nonhighly compensated employees.**

  For tax years beginning after December 31, 2006, there's an exception to the comparable contribution requirements which allows employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. Highly compensated employees are defined as under the Code to include any employee who was: (1) a 5% owner at any time during the year or the preceding year; or (2) for the preceding year, had compensation from the employer in excess of $100,000 (indexed for inflation) and, if elected by the employer, was in the group consisting of the top-20% of employees when ranked based on compensation. Nonhighly compensated employees are those not included in the definition of highly compensated employee.

  The comparability rules are unchanged for contributions made to nonhighly compensated employees. In other words, the employer must make available comparable contributions on behalf of all nonhighly compensated employees with comparable coverage during the same period.

- **One-time-only IRA-to-HSA rollovers.**

  For tax years beginning after December 31, 2007, taxpayers may make a one-time-only tax-free rollover, via direct trustee-to-trustee-transfer, from an IRA (but not a simplified employee pension (SEP) or SIMPLE plan) to an HSA. The amount that can be distributed from the IRA and contributed to an HSA is limited to the otherwise maximum deductible HSA contribution amount, computed on the basis of the type of coverage under the high deductible health plan at the time of the contribution. The amount that can otherwise be contributed to the HSA for the contribution year from the IRA is reduced by the amount contributed from the IRA. No deduction is allowed for the amount contributed from an IRA to an HSA.

  Only one distribution and contribution may be made during a taxpayer's lifetime, except that if a distribution and contribution are made during a month in which he has self-only coverage as of the first day of the month, an additional distribution and contribution may be made during a subsequent month within the tax year in which he has family coverage. The limit applies to the combination of both contributions.

If a taxpayer does not remain an eligible individual (except because of death or disability) during the testing period (which begins with the month of the contribution and ends on the last day of the 12th month following that month), the amount of the IRA distribution that would otherwise have been includible is taxed to him and is subject to a 10% penalty tax. The amount is includible for the tax year of the first day during the testing period that the taxpayer is not an eligible individual.

- **Tax Court Gets Authority to Review Equitable Innocent Spouse Relief**

The Act gives the Tax Court authority to review IRS denials of equitable innocent spouse relief.

Before a 2001 law change (see below), the Tax Court, in Fernandez, (2000) 114 TC 324, held that it had jurisdiction to review a denial of equitable relief in a stand-alone proceeding. In that case, IRS argued that the Tax Court did not have jurisdiction to review denials of equitable relief because the language of the Code limited the Tax Court's jurisdiction. However, the Tax Court rejected IRS's argument, essentially viewing the election language as imposing procedural requirements. Subsequently, IRS agreed the Tax Court had jurisdiction in these situations.

Since the *Fernandez* case was decided, the Code was amended in 2001 to provide, effective on December 31, 2000, an individual can get Tax Court review only if a deficiency has been asserted. That language was added because Congress was concerned individuals were making premature requests for innocent spouse relief. No change was made to the election language.

Despite the 2001 amendment, the Tax Court in Ewing, (2002) 118 TC 494, over a strong dissent, held it had jurisdiction to review IRS's denial of equitable innocent spouse relief even though IRS had not asserted a deficiency. In early 2006, the Court of Appeals for the Ninth Circuit reversed the Tax Court on this issue (see Ewing, (CA 9 2/28/2006) 97 AFTR 2d ¶2006-554). Then in July 2006, in David Bruce Billings, (2006) 127 TC No. 2, the Tax Court reversed itself and held it lacks jurisdiction to review IRS's denial of equitable innocent spouse relief where IRS has not issued a deficiency notice.

New law. The Act amends the Code to provide that the Tax Court may review claims for equitable innocent spouse relief and to suspend the running on the period of limitations while such claims are pending. The changes apply to requests for equitable relief with respect to liability for taxes that are unpaid after the enactment date.

- **Extensions and Changes for Energy-Related Provisions**

The Act extends, adds and modifies these energy provisions:

- *Credit for electricity produced from certain renewable resources extended.* The renewable electricity production tax credit is extended for one year, through December 31, 2008, for electricity produced from wind, closed-loop biomass, open-loop biomass, geothermal, incremental hydroelectric, small irrigation,

landfill gas and trash combustion.

- *Credit for residential energy efficient property extended.* The 30% tax credit for the purchase of residential solar water heating, solar electric equipment and fuel cell property is extended through December 31, 2008.

- *Energy credit for certain business purchases extended.* The Act extends the 30% business tax credit for the purchase of fuel cell power plants and solar equipment through December 31, 2008.

- *Credit to holders of clean renewable energy bonds extended.* The Act extends the clean renewable energy bond (CREB) program through December 31, 2008, and provides for an additional $400 million of CREB bonding authority.

- *New special depreciation allowance for cellulosic biomass ethanol plant property.* The Act provides 50% bonus first-year depreciation for new qualified cellulosic ethanol plants placed in service through December 31, 2012.

- *Reduced excise tax rate for methanol or ethanol fuel derived from coal extended.* The reduced excise tax rate for methanol or ethanol fuel derived from coal is extended for one year through December 31, 2008.

- *Credit for new energy efficient homes extended.* The Act extends the tax credit for builders of new energy efficient homes for one year through December 31, 2008.

- *Deduction for energy efficient commercial buildings extended.* The Act extends for one year, through December 31, 2008, the deduction for energy efficient commercial buildings meeting a 50% energy reduction standard.

- *Qualified expenditures from the LUST fund expanded.* Effective on the enactment date, the Act modifies the Leaking Underground Storage Trust (LUST) Fund to expand the uses for which funds may be spent.

- *Clean coal gasification tax credit modified.* The Act modifies the requirements which must be met to obtain tax credits for subbituminous coal gasification projects to ensure more of these ultra-clean energy facilities are constructed. The change is effective for applications for certification submitted after October 2, 2006.

- *Coke and coke gas production tax credit modified.* The Act eliminates the reference price phase-out provisions for the coke and coke gas production tax credit. The credit remains subject to the per-facility production caps. The changes are effective as if included in section 1321 of the Energy Policy Act of 2005.

■ Mine Safety Provisions

- *Partial Expensing for Advanced Mine Safety Equipment.* The Act provides 50% expensing for certain equipment expenditures related to safety equipment for underground mines located in the U.S., effective for costs paid or incurred

after the enactment date and before December 31, 2008.

- *Mine rescue team training tax credit.* The Act adds tax credits for certain mine rescue team training programs for tax years beginning after 2005 and before 2009.

Whistleblower Reforms

The Act reforms the reward program for individuals who provide information to IRS regarding violations of the tax laws for information provided on or after the enactment date. Specifically, the Act establishes a reward range for such "whistleblowers" of 15% to 30% of proceeds collected by IRS (subject to certain exceptions) where the amount in dispute exceeds $2,000,000. It also provides IRS with regulatory authority to create a Whistleblower Office to administer the program.

Frivolous Tax Submissions Penalty Increased and Modified

The Act increases the penalty for frivolous tax return submissions from $500 to $5,000 and expands the penalty to all taxpayers and all types of Federal taxes. This increased penalty also applies to frivolous submissions for lien and levy collection due process, installment agreements, offers-in-compromise and taxpayer assistance orders. These changes apply for submissions made and issues raised after the date IRS first prescribes a list.

Temporary TIPRA Provisions Made Permanent

The Act makes permanent a number of provisions which were enacted on a temporary basis in the Tax Increase Prevention and Reconciliation Act of 2005 including the following:

- *Tax treatment of environmental cleanup funds.* The provision treating environmental cleanup settlement funds as governmentally-owned (i.e., not subject to tax) if certain standards and requirements are met.

- *Simplification of the active trade or business test.* The provision simplifying the application of the active trade or business test to certain corporate distributions by applying this test on an affiliated group basis.

- *Enhancing veterans' access to affordable mortgages.* The provision expanding eligibility for the qualified veterans' mortgage bond program in a number of States by repealing the requirement that veterans must have served before 1977 and reducing the eligibility period from 30 years to 25 years.

- *Tax treatment of self-created musical works.* The provision providing capital gains treatment for self-created musical works when these works are sold by the artist.

- *Loans to qualified continuing care facilities.* The provision reforming the tax treatment of loans to qualified continuing care facilities.

- **Modification of the Mortgage Revenue Bond Rules for Veterans**

  The Act makes affordable mortgages more accessible to veterans by providing them with a one-time exception from the mortgage revenue bond first-time Home Buyer requirement, effective for mortgage revenue bonds issued before January 1, 2008.

- **Sale of Residences by Intelligence Officers**

  The Act gives non-military intelligence officers parity with active military personnel for the capital gains exclusion on sales of homes provided such officers are stationed abroad, effective for sales before January 1, 2011.

- **Sale of Property by Certain Federal Judicial Officers**

  The Act provides special rollover rules for certain Federal judicial officers who sell property to comply with certain conflict-of-interest requirements.

- **Premiums for Mortgage Insurance**

  The Act establishes an itemized deduction for the cost of premiums for mortgage insurance on a qualified personal residence for amounts paid or accrued after December 31, 2006, and before January 1, 2008. The deduction is phased-out ratably by 10% for each $1,000 by which the taxpayers adjusted gross income exceeds $100,000.

- **Modification of Excise Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts**

  The Act allows charitable remainder trusts that earn unrelated business income to maintain their tax-exempt status by imposing a 100% excise tax on such unrelated business income foe tax years beginning after December 31, 2006.

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