

**DESCRIPTION OF THE  
AMERICAN RECOVERY AND REINVESTMENT  
TAX ACT OF 2009**

Scheduled for Markup  
by the  
SENATE COMMITTEE ON FINANCE  
on January 27, 2009

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The Senate Committee on Finance has scheduled a markup of the American Recovery and Reinvestment Tax Act of 2009. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Mark.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, "*Description of the American Recovery and Reinvestment Tax Act of 2009*," January 23, 2009, (JCX-10-09). This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

## I. TAX RELIEF FOR INDIVIDUALS AND FAMILIES

### 1. Making work pay credit

#### Present Law

##### Earned income tax credit

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

The EITC generally equals a specified percentage of earned income<sup>2</sup> up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer’s Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

##### Child credit

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

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

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<sup>2</sup> Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual’s net self-employment earnings.

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). The threshold dollar amount is \$12,550 (for 2009), and is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit.

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

### **Description of Proposal**

#### **In general**

The proposal provides eligible individuals a refundable income tax credit for two years (taxable years beginning in 2009 and 2010).

The credit is the lesser of (1) 6.2 percent of an individual's earned income or (2) \$500 (\$1,000 in the case of a joint return). For these purposes, the earned income definition is the same as for the earned income tax credit with two modifications. First, earned income for these purposes does not include net earnings from self-employment which are not taken into account in computing taxable income. Second, earned income for these purposes includes combat pay excluded from gross income under section 112.<sup>3</sup>

The credit is phased out at a rate of four percent of the eligible individual's modified adjusted gross income above \$75,000 (\$150,000 in the case of a joint return). For these purposes an eligible individual's modified adjusted gross income is the eligible individual's adjusted gross income increased by any amount excluded from gross income under sections 911, 931, or 933. An eligible individual means any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another individual may claim a dependency deduction for a taxable year beginning in a calendar year in which the eligible individual's taxable year begins; and (3) an estate or trust.

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<sup>3</sup> Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

The otherwise allowable credit allowed under the proposal shall be reduced by the amount of any payment received by the taxpayer pursuant to the proposals of the bill providing special payments under the Department of Veterans' Affairs Administration and the Social Security Administration.

### **Treatment of the U.S. possessions**

#### Mirror code possessions<sup>4</sup>

The U.S. Treasury will make two payments (for 2009 and 2010, respectively) to each mirror code possession in an amount equal to the aggregate amount of the credits allowable by reason of the proposal to that possession's residents against its income tax. This amount will be determined by the Treasury Secretary based on information provided by the government of the respective possession. For purposes of this payment, a possession is a mirror code possession if the income tax liability of residents of the possession under that possession's income tax system is determined by reference to the U.S. income tax laws as if the possession were the United States.

#### Non-mirror code possessions<sup>5</sup>

To each possession that does not have a mirror code tax system, the U.S. Treasury will make two payments (for 2009 and 2010, respectively) in an amount estimated by the Secretary as being equal to the aggregate credits that would have been allowed to residents of that possession if a mirror code tax system had been in effect in that possession. Accordingly, the amount of each payment to a non-mirror Code possession will be an estimate of the aggregate amount of the credits that would be allowed to the possession's residents if the credit provided by the proposal to U.S. residents were provided by the possession to its residents. This payment will not be made to any U.S. possession unless that possession has a plan that has been approved by the Secretary under which the possession will promptly distribute the payment to its residents.

#### General rules

No credit against U.S. income taxes is permitted under the proposal for any person to whom a credit is allowed against possession income taxes as a result of the proposal (for example, under that possession's mirror income tax). Similarly, no credit against U.S. income taxes is permitted for any person who is eligible for a payment under a non-mirror code possession's plan for distributing to its residents the payment described above from the U.S. Treasury.

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<sup>4</sup> Possessions with mirror code tax systems are the United States Virgin Islands, Guam, and the Commonwealth of the Northern Mariana Islands.

<sup>5</sup> Possessions that do not have mirror code tax systems are Puerto Rico and American Samoa.

For purposes of the payments to the possessions, the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands are considered possessions of the United States.

For purposes of the rule permitting the Treasury Secretary to disburse appropriated amounts for refunds due from certain credit proposals of the Internal Revenue Code of 1986, the payments required to be made to possessions under the proposal are treated in the same manner as a refund due from the credit allowed under the proposal.

### **Federal programs or Federally-assisted programs**

Any credit or refund allowed or made to an individual under this proposal (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

### **Income tax withholding**

It is anticipated that taxpayers' reduced tax liability under the proposal shall be expeditiously implemented through revised income tax withholding schedules produced by the Internal Revenue Service. These revised income tax withholding schedules should be designed to reduce taxpayers' income tax withheld for each remaining pay period in the remainder of 2009 so that the full benefit of the proposal is reflected in the income tax withholding schedules during the balance of 2009.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2008.

## **2. Temporary increase in the earned income tax credit**

### **Present Law**

#### **Overview**

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



The EITC generally equals a specified percentage of earned income<sup>6</sup> up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,100 (for 2009). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

### **Filing status**

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year shall not be considered as married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,<sup>7</sup> and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

### **Presence of qualifying children and amount of the earned income credit**

Three separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, and one schedule for taxpayers with more than one qualifying child.<sup>8</sup>

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<sup>6</sup> Earned income is defined as (1) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income, plus (2) the amount of the individual's net self-employment earnings.

<sup>7</sup> A foster child must reside with the taxpayer for the entire taxable year.

<sup>8</sup> All income thresholds are indexed for inflation annually.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$5,970, resulting in a maximum credit of \$457, for 2009. The maximum is available for those with incomes between \$5,970 and \$7,470 (\$10,590 if married filing jointly). The credit begins to phase down at a rate of 7.65 percent of earnings above \$7,470 (\$10,590 if married filing jointly) resulting in a \$0 credit at \$13,440 of earnings (\$16,560 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2009 of 34 percent of their earnings up to \$8,950, resulting in a maximum credit of \$3,043. The maximum credit is available for those with earnings between \$8,950 and \$16,420 (\$19,540 if married filing jointly). The credit begins to phase down at a rate of 15.98 percent of earnings above \$16,420 (\$19,540 if married filing jointly). The credit is phased down to \$0 at \$35,463 of earnings (\$38,583 if married filing jointly).

Taxpayers with more than one qualifying child may claim a credit in 2009 of 40 percent of earnings up to \$12,570, resulting in a maximum credit of \$5,028. The maximum credit is available for those with earnings between \$12,570 and \$16,420 (\$19,540 if married filing jointly). The credit begins to phase down at a rate of 21.06 percent of earnings above \$16,420 (\$19,540 if married filing jointly). The credit is phased down to \$0 at \$40,295 of earnings (\$43,415 if married filing jointly).

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to failure to meet certain identification requirements with respect to such children (i.e., providing the name, age and taxpayer identification number of each of such children) may not claim the EITC for taxpayers without qualifying children.

### **Description of Proposal**

#### **Three or more qualifying children**

The proposal increases the EITC credit percentage for three or more qualifying children to 45 percent for 2009 and 2010. For example, taxpayers with three or more qualifying children may claim a credit in 2009 of 45 percent of earnings up to \$12,570,<sup>9</sup> resulting in a maximum credit of \$5,656.50.

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<sup>9</sup> All income thresholds are indexed for inflation annually.

## **Provide additional marriage penalty relief through higher threshold phase-out amounts for married couples filing joint returns**

The proposal increases the threshold phase-out amounts for married couples filing joint returns to \$5,000<sup>10</sup> above the threshold phase-out amounts for singles, surviving spouses, and heads of households) for 2009 and 2010. For example, in 2009 the maximum credit of \$3,043 for one qualifying child is available for those with earnings between \$8,950 and \$16,420 (\$21,420 if married filing jointly). The credit begins to phase down at a rate of 15.98 percent of earnings above \$16,420 (\$21,420 if married filing jointly). The credit is phased down to \$0 at \$35,463 of earnings (\$40,463 if married filing jointly).

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## **3. Temporary increase of refundable portion of the child credit**

### **Present Law**

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

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

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). The threshold dollar amount is \$12,550 (for 2009), and is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit ("EITC").

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<sup>10</sup> All income thresholds are indexed for inflation annually.

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

Any credit or refund allowed or made to an individual under this proposal (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

### **Description of Proposal**

The proposal modifies the earned income formula for the determination of the refundable child credit to apply to 15 percent of earned income in excess of \$6,000 for taxable years beginning in 2009 and 2010.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## **4. American opportunity tax credit**

### **Present Law**

Individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,800 (for 2009) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.<sup>11</sup> The Hope credit rate is 100 percent on the first \$1,200 of qualified tuition and related expenses, and 50 percent on the next \$1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income phaseout described below) for a \$1,200 Hope credit. If a taxpayer incurs \$2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,800 Hope credit.

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<sup>11</sup> Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2009.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$50,000 and \$60,000 (\$100,000 and \$120,000 for married taxpayers filing a joint return) for 2009. The adjusted gross income phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of \$1,000.

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

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

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

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

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

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

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

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") no longer apply. The principal EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

### **Description of Proposal**

The proposal modifies the Hope credit for taxable years beginning in 2009 or 2010. The modified credit is referred to as the American opportunity tax credit. The allowable modified credit is up to \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

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

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

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

In addition, the proposal requires the Secretary of the Treasury to conduct two studies and submit a report to Congress on the results of those studies within one year after the date of enactment. The first study shall examine how to coordinate the Hope and Lifetime Learning credits with the Pell grant program. The second study shall examine requiring students to perform community service as a condition of taking their tuition and related expenses into account for purposes of the Hope and Lifetime Learning credits.

### **Effective Date**

The proposal is effective with respect to taxable years beginning after December 31, 2008.

## **5. Temporarily allow computer technology and equipment as a qualified higher education expense for qualified tuition programs**

### **Present Law**

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.<sup>12</sup> A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified

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<sup>12</sup> For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

higher education expenses generally also include room and board for students who are enrolled at least half-time.

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

Distributions from a qualified tuition program are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary. If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner") whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.<sup>13</sup>

### **Description of Proposal**

The proposal expands the definition of qualified higher education expenses for taxable years beginning in 2009 and 2010 to include expenses for computer technology and equipment.

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<sup>13</sup> Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.



### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## **6. Waiver of requirement to repay first-time homebuyer credit**

### **Present Law**

A taxpayer who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of \$7,500 (\$3,750 for a married individual filing separately) or 10 percent of the purchase price of a principal residence. The credit is allowed for the tax year in which the taxpayer purchases the home unless the taxpayer makes an election as described below. The credit is allowed for qualifying home purchases on or after April 9, 2008 and before July 1, 2009 (without regard to whether there was a binding contract to purchase prior to April 9, 2008).

The credit phases out for individual taxpayers with modified adjusted gross income between \$75,000 and \$95,000 (\$150,000-\$170,000 for joint filers) for the year of purchase.

A taxpayer is considered a first-time homebuyer if such individual had no ownership interest in a principal residence in the United States during the 3-year period prior to the purchase of the home to which the credit applies.

No credit is allowed if the D.C. homebuyer credit is allowable for the taxable year the residence is purchased or a prior taxable year. A taxpayer is not permitted to claim the credit if the taxpayer's financing is from tax-exempt mortgage revenue bonds, if the taxpayer is a nonresident alien, or if the taxpayer disposes of the residence (or it ceases to be a principal residence) before the close of a taxable year for which a credit otherwise would be allowable.

The credit is recaptured ratably over fifteen years with no interest charge beginning in the second taxable year after the taxable year in which the home is purchased. For example, if the taxpayer purchases a home in 2008, the credit is allowed on the 2008 tax return, and repayments commence with the 2010 tax return. If the taxpayer sells the home (or the home ceases to be used as the principal residence of the taxpayer or the taxpayer's spouse) prior to complete repayment of the credit, any remaining credit repayment amount is due on the tax return for the year in which the home is sold (or ceases to be used as the principal residence). However, the credit repayment amount may not exceed the amount of gain from the sale of the residence to an unrelated person. For this purpose, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured. No amount is recaptured after the death of a taxpayer. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two year period. In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture.

An election is provided to treat a home purchased in the eligible period in 2009 as if purchased on December 31, 2008 for purposes of claiming the credit on the 2008 tax return and for establishing the beginning of the recapture period. Taxpayers may amend their returns for this purpose.

### **Description of Proposal**

The proposal waives the recapture of the credit for qualifying home purchases after December 31, 2008 and before July 1, 2009. This waiver of recapture applies without regard to whether the taxpayer elects to treat the purchase in 2009 as occurring on December 31, 2008. If the taxpayer disposes of the home, or the home otherwise ceases to be the principal residence of the taxpayer, within 36 months from the date of purchase, the present law rules for recapture of the credit will still apply.

### **Effective Date**

The proposal shall apply to residences purchased after December 31, 2008.

## **7. Exclusion from gross income for unemployment compensation benefits**

### **Present Law**

An individual must include in gross income any unemployment compensation benefits received under the laws of the United States or any State.

### **Description of Proposal**

Up to \$2,400 of unemployment compensation benefits received in 2009 are excluded from gross income by the recipient.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## II. RENEWABLE ENERGY INCENTIVES

### 1. Extension of the renewable electricity credit

#### Present Law

##### In general

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.<sup>14</sup> Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

##### Credit amounts and credit period

###### In general

The base amount of the electricity production credit is 1.5 cents per kilowatt-hour (indexed annually for inflation) of electricity produced. The amount of the credit was 2.1 cents per kilowatt-hour for 2008. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

###### Credit phaseout

The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. The electricity production credit is reduced over a 3-cent phaseout range to the extent the annual average contract price per kilowatt-hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation; 11.8 cents for 2008).

###### Reduced credit periods and credit amounts

Generally, in the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities placed in service before August 8, 2005, the 10-year credit period is reduced to five years, commencing on the date the facility was originally placed in service. However, for qualified open-loop biomass facilities (other than a facility described in section 45(d)(3)(A)(i) that uses agricultural livestock waste nutrients) placed in service before October 22, 2004, the five-year period commences on

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<sup>14</sup> Sec. 45. In addition to the electricity production credit, section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (1 cent per kilowatt-hour for 2008).

#### Other limitations on credit claimants and credit amounts

In general, in order to claim the credit, a taxpayer must own the qualified facility and sell the electricity produced by the facility to an unrelated party. A lessee or operator may claim the credit in lieu of the owner of the qualifying facility in the case of qualifying open-loop biomass facilities and in the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee or operator of a facility owned by a governmental unit.

For all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit for electricity produced from renewable resources is a component of the general business credit.<sup>15</sup> Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or 25 percent of so much of the net regular tax liability as exceeds \$25,000. However, this limitation does not apply to section 45 credits for electricity or refined coal produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.<sup>16</sup> Excess credits may be carried back one year and forward up to 20 years.

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<sup>15</sup> Sec. 38(b)(8).

<sup>16</sup> Sec. 38(c)(4)(B)(ii).

## **Qualified facilities**

### Wind energy facility

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2010.

### Closed-loop biomass facility

A closed-loop biomass facility is a facility that uses any organic material from a plant which is planted exclusively for the purpose of being used at a qualifying facility to produce electricity. In addition, a facility can be a closed-loop biomass facility if it is a facility that is modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both coal and other biomass, but only if the modification is approved under the Biomass Power for Rural Development Programs or is part of a pilot project of the Commodity Credit Corporation.

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2011. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2011.

A qualified facility includes a new power generation unit placed in service after October 3, 2008, at an existing closed-loop biomass facility, but only to the extent of the increased amount of electricity produced at the existing facility by reason of such new unit.

### Open-loop biomass (including agricultural livestock waste nutrients) facility

An open-loop biomass facility is a facility that uses open-loop biomass to produce electricity. For purposes of the credit, open-loop biomass is defined as (1) any agricultural livestock waste nutrients or (2) any solid, nonhazardous, cellulosic waste material or any lignin material that is segregated from other waste materials and which is derived from:

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimmings; or
- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure. Wood waste materials do not qualify as open-loop biomass to the extent they are pressure treated, chemically treated, or painted. In addition, municipal solid waste, gas derived from the biodegradation of solid waste, and paper which is commonly recycled do not qualify as open-loop biomass. Open-loop

biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2009, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2011. A qualified facility includes a new power generation unit placed in service after October 3, 2008, at an existing open-loop biomass facility, but only to the extent of the increased amount of electricity produced at the existing facility by reason of such new unit.

#### Geothermal facility

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit that is a geothermal reservoir consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after October 22, 2004, and before January 1, 2011.

#### Solar facility

A solar facility is a facility that uses solar energy to produce electricity. To be a qualified facility, a solar facility must be placed in service after October 22, 2004, and before January 1, 2006.

#### Small irrigation facility

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility must be at least 150 kilowatts but less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after October 22, 2004, and before October 3, 2008. Marine and hydrokinetic renewable energy facilities, described below, subsume small irrigation power facilities after October 2, 2008.

#### Landfill gas facility

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004, and before January 1, 2011.

#### Trash combustion facility

Trash combustion facilities are facilities that use municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004, and before January 1, 2011. A qualified trash combustion facility includes a new unit, placed in service after

October 22, 2004, that increases electricity production capacity at an existing trash combustion facility. A new unit generally would include a new burner/boiler and turbine. The new unit may share certain common equipment, such as trash handling equipment, with other pre-existing units at the same facility. Electricity produced at a new unit of an existing facility qualifies for the production credit only to the extent of the increased amount of electricity produced at the entire facility.

#### Hydropower facility

A qualifying hydropower facility is (1) a facility that produced hydroelectric power (a hydroelectric dam) prior to August 8, 2005, at which efficiency improvements or additions to capacity have been made after such date and before January 1, 2011, that enable the taxpayer to produce incremental hydropower or (2) a facility placed in service before August 8, 2005, that did not produce hydroelectric power (a nonhydroelectric dam) on such date, and to which turbines or other electricity generating equipment have been added after such date and before January 1, 2011.

At an existing hydroelectric facility, the taxpayer may claim credit only for the production of incremental hydroelectric power. Incremental hydroelectric power for any taxable year is equal to the percentage of average annual hydroelectric power produced at the facility attributable to the efficiency improvement or additions of capacity determined by using the same water flow information used to determine an historic average annual hydroelectric power production baseline for that facility. The Federal Energy Regulatory Commission will certify the baseline power production of the facility and the percentage increase due to the efficiency and capacity improvements.

Nonhydroelectric dams converted to produce electricity must be licensed by the Federal Energy Regulatory Commission and meet all other applicable environmental, licensing, and regulatory requirements.

For a nonhydroelectric dam converted to produce electric power before January 1, 2009, there must not be any enlargement of the diversion structure, construction or enlargement of a bypass channel, or the impoundment or any withholding of additional water from the natural stream channel.

For a nonhydroelectric dam converted to produce electric power after December 31, 2008, the nonhydroelectric dam (1) must have been placed in service before October 3, 2008, (2) must have been operated for flood control, navigation, or water supply purposes and (3) must not have produced hydroelectric power on October 3, 2008. In addition, the hydroelectric project must be operated so that the water surface elevation at any given location and time that would have occurred in the absence of the hydroelectric project is maintained, subject to any license requirements imposed under applicable law that change the water surface elevation for the purpose of improving environmental quality of the affected waterway. The Secretary, in consultation with the Federal Energy Regulatory Commission, shall certify if a hydroelectric project licensed at a nonhydroelectric dam meets this criteria.

Marine and hydrokinetic renewable energy facility

A qualified marine and hydrokinetic renewable energy facility is any facility that produces electric power from marine and hydrokinetic renewable energy, has a nameplate capacity rating of at least 150 kilowatts, and is placed in service after October 2, 2008, and before January 1, 2012. Marine and hydrokinetic renewable energy is defined as energy derived from (1) waves, tides, and currents in oceans, estuaries, and tidal areas; (2) free flowing water in rivers, lakes, and streams; (3) free flowing water in an irrigation system, canal, or other man-made channel, including projects that utilize nonmechanical structures to accelerate the flow of water for electric power production purposes; or (4) differentials in ocean temperature (ocean thermal energy conversion). The term does not include energy derived from any source that uses a dam, diversionary structure (except for irrigation systems, canals, and other man-made channels), or impoundment for electric power production.

**Summary of credit rate and credit period by facility type**

**Table 1.–Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources**

<b>Eligible electricity production activity</b>	<b>Credit amount for 2008 (cents per kilowatt-hour)</b>	<b>Credit period for facilities placed in service on or before August 8, 2005 (years from placed-in-service date)</b>	<b>Credit period for facilities placed in service after August 8, 2005 (years from placed-in-service date)</b>
Wind	2.1	10	10
Closed-loop biomass	2.1	10 <sup>1</sup>	10
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1.0	5 <sup>2</sup>	10
Geothermal	2.1	5	10
Solar (pre-2006 facilities only)	2.1	5	10
Small irrigation power	1.0	5	10
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1.0	5	10
Qualified hydropower	1.0	N/A	10
Marine and hydrokinetic	1.0	N/A	10

<sup>1</sup> In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.

<sup>2</sup> For certain facilities placed in service before October 22, 2004, the five-year credit period commences on January 1, 2005.



## **Taxation of cooperatives and their patrons**

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception: the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, a cooperative that is subject to the cooperative tax rules of subchapter T of the Code<sup>17</sup> is permitted a deduction for patronage dividends paid only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.<sup>18</sup> The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Eligible cooperatives may elect to pass any portion of the credit through to their patrons. An eligible cooperative is defined as a cooperative organization that is owned more than 50 percent by agricultural producers or entities owned by agricultural producers. The credit may be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year and, once made, is irrevocable for such taxable year.

### **Description of Proposal**

The proposal extends for three years (generally, through 2013; through 2012 for wind facilities) the period during which qualified facilities producing electricity from wind, closed-loop biomass, open-loop biomass, geothermal energy, municipal solid waste, and qualified hydropower may be placed in service for purposes of the electricity production credit. The proposal extends for two years (through 2013) the placed-in-service period for marine and hydrokinetic renewable energy resources.

The proposal also makes a technical amendment to the definition of small irrigation power facility to clarify its integration into the definition marine and hydrokinetic renewable energy facility.

### **Effective Date**

The extension of the electricity production credit is effective for property placed in service after the date of enactment. The technical amendment is effective as if included in section 102 of the Energy Improvement and Extension Act of 2008.

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<sup>17</sup> Secs. 1381-1383.

<sup>18</sup> Sec. 1382.

## **2. Election of investment credit in lieu of production tax credits**

### **Present Law**

#### **Renewable Electricity Credit**

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.<sup>19</sup> Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. The credit amounts, credit periods, definitions of qualified facilities, and other rules governing this credit are described more fully in section II.1. of this document.

#### **Energy Credit**

An income tax credit is also allowed for certain energy property placed in service. Qualifying property includes certain fuel cell property, solar property, geothermal power production property, small wind energy property, combined heat and power system property, microturbine property, and geothermal heat pump property.<sup>20</sup> The amounts of credit, definitions of qualifying property, and other rules governing this credit are described more fully in section II.3. of this document.

### **Description of Proposal**

The proposal allows the taxpayer to make an irrevocable election to have certain qualified facilities placed in service in 2009 and 2010 be treated as energy property eligible for a 30 percent investment credit under section 48. For this purpose, qualified facilities are facilities otherwise eligible for the section 45 production tax credit (other than refined coal, Indian coal, and solar facilities) with respect to which no credit under section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the production credit under section 45.

### **Effective Date**

The proposal applies to facilities placed in service after December 31, 2008.

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<sup>19</sup> Sec. 45. In addition to the electricity production credit, section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

<sup>20</sup> Sec. 48.

### **3. Modification of energy credit<sup>21</sup>**

#### **Present Law**

##### **In general**

A nonrefundable, 10-percent business energy credit<sup>22</sup> is allowed for the cost of new property that is equipment that either (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

The energy credit is a component of the general business credit.<sup>23</sup> An unused general business credit generally may be carried back one year and carried forward 20 years.<sup>24</sup> The taxpayer's basis in the property is reduced by one-half of the amount of the credit claimed. For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. The credit is allowed against the alternative minimum tax for credits determined in taxable years beginning after October 3, 2008.

Property financed by subsidized energy financing or with proceeds from private activity bonds is subject to a reduction in basis for purposes of claiming the credit. The basis reduction is proportional to the share of the basis of the property that is financed by the subsidized financing or proceeds. The term "subsidized energy financing" means financing provided under a Federal, State, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

##### **Special rules for solar energy property**

The credit for solar energy property is increased to 30 percent in the case of periods prior to January 1, 2017. Additionally, equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit.

##### **Fuel cells and microturbines**

The energy credit applies to qualified fuel cell power plants, but only for periods prior to January 1, 2017. The credit rate is 30 percent.

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<sup>21</sup> An additional proposal that allows section 45 facilities to elect to be treated as section 48 energy property is described in section II.2 of this document.

<sup>22</sup> Sec. 48.

<sup>23</sup> Sec. 38(b)(1).

<sup>24</sup> Sec. 39.

A qualified fuel cell power plant is an integrated system composed of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, and (2) has an electricity-only generation efficiency of greater than 30 percent and a capacity of at least one-half kilowatt. The credit may not exceed \$1,500 for each 0.5 kilowatt of capacity.

The energy credit applies to qualifying stationary microturbine power plants for periods prior to January 1, 2017. The credit is limited to the lesser of 10 percent of the basis of the property or \$200 for each kilowatt of capacity.

A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components that converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less than 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts.

### **Geothermal heat pump property**

The energy credit applies to qualified geothermal heat pump property placed in service prior to January 1, 2017. The credit rate is 10 percent. Qualified geothermal heat pump property is equipment that uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure.

### **Small wind property**

The energy credit applies to qualified small wind energy property placed in service prior to January 1, 2017. The credit rate is 30 percent. The credit is limited to \$4,000 per year with respect to all wind energy property of any taxpayer. Qualified small wind energy property is property that uses a qualified wind turbine to generate electricity. A qualifying wind turbine means a wind turbine of 100 kilowatts of rated capacity or less.

### **Combined heat and power property**

The energy credit applies to combined heat and power (“CHP”) property placed in service prior to January 1, 2017. The credit rate is 10 percent.

CHP property is property: (1) that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) that has an electrical capacity of not more than 50 megawatts or a mechanical energy capacity of no more than 67,000 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy that is not used to produce electrical or mechanical power, and produces at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60

percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

The otherwise allowable credit with respect to CHP property is reduced to the extent the property has an electrical capacity or mechanical capacity in excess of any applicable limits. Property in excess of the applicable limit (15 megawatts or a mechanical energy capacity of more than 20,000 horsepower or an equivalent combination of electrical and mechanical energy capacities) is permitted to claim a fraction of the otherwise allowable credit. The fraction is equal to the applicable limit divided by the capacity of the property. For example, a 45 megawatt property would be eligible to claim 15/45ths, or one third, of the otherwise allowable credit. Again, no credit is allowed if the property exceeds the 50 megawatt or 67,000 horsepower limitations described above.

Additionally, the proposal provides that systems whose fuel source is at least 90 percent open-loop biomass and that would qualify for the credit but for the failure to meet the efficiency standard are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

### **Description of Proposal**

The proposal eliminates the credit caps applicable to qualified small wind energy property. The proposal also removes the rule that reduces the basis of the property for purposes of claiming the credit if the property is financed in whole or in part by subsidized energy financing or with proceeds from private activity bonds.

### **Effective Date**

The proposal applies to periods after December 31, 2008, under rules similar to the rules of section 48(m) of the Code (as in effect on the day before the enactment of the Revenue Reconciliation Act of 1990).

## **4. Expand new clean renewable energy bonds**

### **Present Law**

#### **New Clean Renewable Energy Bonds**

New clean renewable energy bonds (“New CREBs”) may be issued by qualified issuers to finance qualified renewable energy facilities. Qualified renewable energy facilities are facilities: (1) that qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) that are owned by a public power provider, governmental body, or cooperative electric company.

The term “qualified issuers” includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a

loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. The term “public power provider” means a State utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act (as in effect on the date of the enactment of this paragraph). A “governmental body” means any State or Indian tribal government, or any political subdivision thereof. The term “cooperative electric company” means a mutual or cooperative electric company (described in section 501(c)(12) or section 1381(a)(2)(C)). A clean renewable energy bond lender means a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002 (including any affiliated entity which is controlled by such lender).

There is a national limitation for New CREBs of \$800 million. No more than one third of the national limit may be allocated to projects of public power providers, governmental bodies, or cooperative electric companies. Allocations to governmental bodies and cooperative electric companies may be made in the manner the Secretary determines appropriate. Allocations to projects of public power providers shall be made, to the extent practicable, in such manner that the amount allocated to each such project bears the same ratio to the cost of such project as the maximum allocation limitation to projects of public power providers bears to the cost of all such projects.

New CREBs are a type of qualified tax credit bond for purposes of section 54A of the Code. As such, 100 percent of the available project proceeds of New CREBs must be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as New CREBs if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the qualified issuer’s request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

New CREBs generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the New CREBs are issued.

The maturity of New CREBs is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the New CREBs are issued.

As with other tax credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. Unlike CREBs, however, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer. The applicable credit rate for the bond is the rate that the Secretary estimates will permit the issuance of the qualified tax credit bond with a specified maturity or redemption date without discount and without interest cost to the qualified issuer.<sup>25</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings.

The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount of the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

An issuer of New CREBs is treated as meeting the "prohibition on financial conflicts of interest" requirement in section 54A(d)(6) if it certifies that it satisfies (i) applicable State and local law requirements governing conflicts of interest and (ii) any additional conflict of interest rules prescribed by the Secretary with respect to any Federal, State, or local government official directly involved with the issuance of New CREBs.

### **Description of Proposal**

The proposal expands the New CREBs program. The proposal authorizes issuance of up to an additional \$1.6 billion of New CREBs.

### **Effective Date**

The proposal applies to bonds issued after the date of enactment.

## **5. Expand qualified energy conservation bonds**

### **Present Law**

Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term "qualified conservation purpose" means:

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<sup>25</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

1. Capital expenditures incurred for purposes of reducing energy consumption in publicly owned buildings by at least 20 percent; implementing green community programs; rural development involving the production of electricity from renewable energy resources; or any facility eligible for the production tax credit under section 45 (other than Indian coal and refined coal production facilities);
2. Expenditures with respect to facilities or grants that support research in: (A) development of cellulosic ethanol or other nonfossil fuels; (B) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (C) increasing the efficiency of existing technologies for producing nonfossil fuels; (D) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (E) technologies to reduce energy use in buildings;
3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;
4. Demonstration projects designed to promote the commercialization of: (A) green building technology; (B) conversion of agricultural waste for use in the production of fuel or otherwise; (C) advanced battery manufacturing technologies; (D) technologies to reduce peak-use of electricity; and (E) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and
5. Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There is a national limitation on qualified energy conservation bonds of \$800 million. Allocations of qualified energy conservation bonds are made to the States with sub-allocations to large local governments. Allocations are made to the States according to their respective populations, reduced by any sub-allocations to large local governments (defined below) within the States. Sub-allocations to large local governments shall be an amount of the national qualified energy conservation bond limitation that bears the same ratio to the amount of such limitation that otherwise would be allocated to the State in which such large local government is located as the population of such large local government bears to the population of such State. The term large local government means: any municipality or county if such municipality or county has a population of 100,000 or more. Indian tribal governments also are treated as large local governments for these purposes (without regard to population).

Each State or large local government receiving an allocation of qualified energy conservation bonds may further allocate issuance authority to issuers within such State or large local government. However, any allocations to issuers within the State or large local government shall be made in a manner that results in not less than 70 percent of the allocation of qualified energy conservation bonds to such State or large local government being used to designate bonds that are not private activity bonds (i.e., the bond cannot meet the private business tests or the private loan test of section 141).



Qualified energy conservation bonds are a type of qualified tax credit bond for purposes of section 54A of the Code. As a result, 100 percent of the available project proceeds of qualified energy conservation bonds must be used for qualified conservation purposes. In the case of qualified conservation bonds issued as private activity bonds, 100 percent of the available project proceeds must be used for capital expenditures. In addition, qualified energy conservation bonds may be issued by Indian tribal governments only to the extent such bonds are issued for purposes that satisfy the present law requirements for tax-exempt bonds issued by Indian tribal governments (i.e., essential governmental functions and certain manufacturing purposes).

Under present law 100 percent of the available project proceeds of qualified energy conservation bonds must be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified conservation purposes during the three-year spending period, bonds will continue to qualify as qualified energy conservation bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified energy conservation bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

The maturity of qualified energy conservation bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

As with other tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.<sup>26</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers

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<sup>26</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount of the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Issuers of qualified energy conservation bonds are required to certify that the financial disclosure requirements that applicable State and local law requirements governing conflicts of interest are satisfied with respect to such issue, as well as any other additional conflict of interest rules prescribed by the Secretary with respect to any Federal, State, or local government official directly involved with the issuance of qualified energy conservation bonds.

### **Description of Proposal**

The proposal expands the present-law qualified energy conservation bond program. The proposal authorizes issuance of an additional \$2.4 billion of qualified energy conservation bonds.

### **Effective Date**

The proposal applies to bonds issued after the date of enactment.

## **6. Extension and modification of credit for nonbusiness energy property**

### **Present Law**

Section 25C provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes. A qualified energy efficiency improvement is any energy efficiency building envelope component (1) that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code as supplemented and as in effect on August 8, 2005 (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (2) exterior windows (including skylights) and doors; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

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

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

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

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which has a heating seasonal performance factor (HSPF) of at least 9, a seasonal energy efficiency ratio (SEER) of at least 15, and an energy efficiency ratio (EER) of at least 13, (3) a central air conditioner with energy efficiency of at least the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2006<sup>27</sup>, (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.80 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

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

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

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

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

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<sup>27</sup> The highest tier in effect at this time was tier 2, requiring SEER of at least 15 and EER of at least 12.5 for split central air conditioning systems and SEER of at least 14 and EER of at least 12 for packaged central air conditioning systems.

The credit applies to expenditures made after December 31, 2008 for property placed in service after December 31, 2008, and prior to January 1, 2010.

### **Description of Proposal**

The proposal raises the 10 percent credit rate to 30 percent. Additionally, all energy property otherwise eligible for the \$50, \$100, or \$150 credits is instead eligible for a 30 percent credit on expenditures for such property.

The proposal additionally extends the proposal for one year, through December 31, 2010. Finally, the \$500 lifetime cap (and the \$200 lifetime cap with respect to windows) is eliminated and replaced with an aggregate cap of \$1,500 in the case of property placed in service after December 31, 2008 and prior to January 1, 2011.

The present law rule related to subsidized energy financing is eliminated.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## **7. Credit for residential energy efficient property**

### **Present Law**

Section 25D provides a personal tax credit for the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures, with a maximum credit of \$2,000 with respect to qualified solar water heating property. There is no cap with respect to qualified solar electric property.

Section 25D also provides a 30 percent credit for the purchase of qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants. The credit for geothermal heat pump property is capped at \$2,000, the credit for qualified small wind energy property is limited to \$500 with respect to each half kilowatt of capacity, not to exceed \$4,000, and the credit for any fuel cell may not exceed \$500 for each 0.5 kilowatt of capacity.

The credit with respect to all qualifying property may be claimed against the alternative minimum tax.

Qualified solar electric property is property that uses solar energy to generate electricity for use in a dwelling unit. Qualifying solar water heating property is property used to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun.

A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30

percent. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

Qualified small wind energy property is property that uses a wind turbine to generate electricity for use in a dwelling unit located in the U.S. and used as a residence by the taxpayer.

Qualified geothermal heat pump property means any equipment which (1) uses the ground or ground water as a thermal energy source to heat the dwelling unit or as a thermal energy sink to cool such dwelling unit, (2) meets the requirements of the Energy Star program which are in effect at the time that the expenditure for such equipment is made, and (3) is installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer.

The credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

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

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

The credit applies to property placed in service prior to January 1, 2017.

### **Description of Proposal**

The proposal eliminates the credit caps for solar hot water, geothermal, and wind property and eliminates the reduction in credits for property using subsidized energy financing.

### **Effective Date**

The proposal is effective for property placed in service after December 31, 2008, in taxable years ending after such date.

## **8. Temporary increase in credit for alternative fuel vehicle refueling property**

### **Present Law**

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the

principal residence of the taxpayer.<sup>28</sup> The credit may not exceed \$30,000 per taxable year per location, in the case of qualified refueling property used in a trade or business and \$1,000 per taxable year per location, in the case of qualified refueling property installed on property which is used as a principal residence.

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

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

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

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

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

### **Description of Proposal**

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

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

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<sup>28</sup> Sec. 30C.

## 9. Energy research credit

### Present Law

#### General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.<sup>29</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.<sup>30</sup>

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

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009.<sup>31</sup>

#### Computation of allowable credit

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

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<sup>29</sup> Sec. 41.

<sup>30</sup> Sec. 41(e).

<sup>31</sup> Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.<sup>32</sup>

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.<sup>33</sup> Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.<sup>34</sup>

### **Alternative incremental research credit regime**

Taxpayers are allowed to elect an alternative incremental research credit regime.<sup>35</sup> If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage

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<sup>32</sup> The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

<sup>33</sup> Sec. 41(f)(1).

<sup>34</sup> Sec. 41(f)(3).

<sup>35</sup> Sec. 41(c)(4).



of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above are increased to three percent, four percent, and five percent, respectively.<sup>36</sup>

An election to be subject to this alternative incremental credit regime can be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury. The alternative incremental credit regime terminates for taxable years beginning after December 31, 2008.

### **Alternative simplified credit**

Generally, for amounts paid or incurred after 2006, taxpayers may elect to claim an alternative simplified credit for qualified research expenses.<sup>37</sup> The alternative simplified research credit is equal to 12 percent (14 percent for taxable years beginning after December 31, 2008) of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes January 1, 2007. The transition rule applies only to the taxable year which includes that date.

### **Eligible expenses**

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).<sup>38</sup> Notwithstanding the limitation for

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<sup>36</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>37</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>38</sup> Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research,

contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.<sup>39</sup> In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.<sup>40</sup> Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

### **Relation to deduction**

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.<sup>41</sup> However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.<sup>42</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>43</sup>

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and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

<sup>39</sup> Sec. 41(d)(3).

<sup>40</sup> Sec. 41(d)(4).

<sup>41</sup> Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

<sup>42</sup> Sec. 280C(c).

<sup>43</sup> Sec. 280C(c)(3).

### **Description of Proposal**

The proposal creates a new 20 percent credit for all qualified energy research expenses paid or incurred in 2009 or 2010. Qualified energy research expenses are qualified research expenses related to the fields of fuel cells and battery technology, renewable energy, energy conservation technology, efficient transmission and distribution of electricity, and carbon capture and sequestration.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## **10. Five-year carryback of general business credit**

### **Present Law**

Present law permits a credit against tax for the sum of the business credit carryforwards carried to the taxable year, the amount of the current year business credit, and the business credit carrybacks carried to the taxable year.<sup>44</sup> The business credit is comprised of several different credits, such as the work opportunity credit, the research credit, and the low-income housing credit.<sup>45</sup> The business credit for any taxable year may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds \$25,000.<sup>46</sup> Business credits in excess of the limitation may be carried back one taxable year and forward up to 20 taxable years.<sup>47</sup>

### **Description of Proposal**

The proposal extends the carryback period of business credits from 2008 and 2009 to five years.

### **Effective Date**

The proposal is effective for taxable years ending after December 31, 2007, and to carrybacks of business credits from such taxable years.

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<sup>44</sup> Sec. 38(a).

<sup>45</sup> See section 38(b) for a complete list of business credits.

<sup>46</sup> Sec. 38(c)(1).

<sup>47</sup> Sec. 39(a)(1).

## **11. Temporary provision allowing general business credits to offset 100 percent of Federal income tax liability**

### **Present Law**

The business credit for any taxable year may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds \$25,000.<sup>48</sup>

### **Description of Proposal**

The proposal allows business credits carried to taxable years ending in 2008 and 2009 to offset the entire net income tax without regard to the present-law limitation. The proposal also allows carrybacks of business credits from taxable years ending in 2008 and 2009 to offset the entire net income tax without regard to the present-law limitation.

The proposal may be illustrated by the following examples:

Example 1.—Taxpayer has a \$50 business credit carryover to 2008. In 2008, Taxpayer has \$60 of net income tax, \$40 of tentative minimum tax, and \$0 of current year business credit. The business credit allowed in 2008 is \$50.

Example 2.—Taxpayer has a \$100 business credit carryover from 2002. In 2003, Taxpayer has \$100 of net income tax, \$60 of tentative minimum tax, and \$0 of current year business credit. In 2003, the taxpayer uses \$40 of its business credit carryover under the limitation in section 38(c) and carries forward the remaining \$60. In 2004 through 2007, Taxpayer utilizes \$20 of the carryover and has \$40 remaining. In 2008, Taxpayer has \$0 of net income tax, \$0 of tentative minimum tax, and \$100 of current year business credits. Taxpayer may carryback the \$40 credit carryover from prior years and \$20 of the 2008 credit to offset the \$60 of net income tax (equal to the tentative minimum tax) in 2003.<sup>49</sup>

### **Effective Date**

The proposal is effective for taxable years ending after December 31, 2007, and to carrybacks of business credits from such taxable years.

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<sup>48</sup> Sec. 38(c)(1).

<sup>49</sup> The business credit carryback period is extended to five years for 2008 and 2009 carrybacks in another section of the Chairman's Mark.

### III. TAX INCENTIVES FOR BUSINESS

#### 1. Special allowance for certain property acquired during 2009

##### Present Law

Present law permits an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property.<sup>50</sup> The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.<sup>51</sup> The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the proposal applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2008, a taxpayer purchases new depreciable property and places it in service.<sup>52</sup> The property's cost is \$1,000, and it is 5-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is \$500. The remaining \$500 of the cost of the property is deductible under the rules applicable to 5-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2008. The total depreciation deduction with respect to the property for 2008 is \$600. The remaining \$400 cost of the property is recovered under otherwise applicable rules for computing depreciation.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be (1) property to which the modified accelerated cost recovery system ("MACRS") applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).<sup>53</sup> Second, the original use<sup>54</sup> of

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<sup>50</sup> Sec. 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or instead is subject to capitalization under section 263 or section 263A.

<sup>51</sup> However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

<sup>52</sup> Assume that the cost of the property is not eligible for expensing under section 179.

<sup>53</sup> A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS.

the property must commence with the taxpayer after December 31, 2007.<sup>55</sup> Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2009. An extension of the placed in service date of one year (i.e., to January 1, 2010) is provided for certain property with a recovery period of ten years or longer and certain transportation property.<sup>56</sup> Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after December 31, 2007, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (2) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2009.<sup>57</sup> With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after December 31, 2007, and before January 1, 2009. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred

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<sup>54</sup> The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

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

<sup>55</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

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

<sup>56</sup> In order for property to qualify for the extended placed in service date, the property is required to have an estimated production period exceeding one year and a cost exceeding \$1 million.

<sup>57</sup> Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to January 1, 2008.

before January 1, 2009 (“progress expenditures”) is eligible for the additional first-year depreciation.<sup>58</sup>

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

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

Corporations otherwise eligible for additional first-year depreciation under section 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for “eligible qualified property.”<sup>59</sup>

### **Description of Proposal**

The proposal extends the additional first-year depreciation deduction for one year, generally through 2009 (through 2010 for certain longer-lived and transportation property).

The proposal modifies the definition of qualified property to include certain motion picture film or video tape (within the meaning of section 168(f)(3)) for which a deduction is allowable under section 167(a) (without regard to section 168) and with respect to which an election is not in effect under section 181. For purposes of the election out of bonus depreciation, all motion picture film and video tape property is treated as one class of property. The proposal does not apply to any property for which records are required under section 2257 of Title 18 U.S.C. to be maintained with respect to any performer in such film or video.

The proposal does not modify the property eligible for the election to accelerate AMT and research credits in lieu of bonus depreciation under section 168(k)(4).<sup>60</sup>

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<sup>58</sup> For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

<sup>59</sup> Sec. 168(k)(4).

## Effective Date

The proposal is generally effective for property placed in service after December 31, 2008.

The technical amendment to section 168(k)(4)(D) is effective for taxable years ending after March 31, 2008.

## **2. Temporary increase in limitations on expensing of certain depreciable business assets**

### Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or “expense”) such costs under section 179. Present law provides that the maximum amount a taxpayer may expense for taxable years beginning in 2008 is \$250,000 of the cost of qualifying property placed in service for the taxable year.<sup>61</sup> For taxable years beginning in 2009 and 2010, the limitation is \$125,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property. For taxable years beginning in 2008, the \$250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000. For taxable years beginning in 2009 and 2010, the \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. The \$125,000 and \$500,000 amounts are indexed for inflation in taxable years beginning in 2009 and 2010.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this proposal). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.<sup>62</sup>

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<sup>60</sup> The proposal includes a technical amendment to section 168(k)(4)(D) providing that no written binding contract for the acquisition of eligible qualified property may be in effect before April 1, 2008.

<sup>61</sup> Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A) or a renewal community (sec. 1400J), qualified section 179 Gulf Opportunity Zone property (sec. 1400N(e)), qualified Recovery Assistance property placed in service in the Kansas disaster area (Pub. L. No. 110-234, sec. 15345 (2008)), and qualified disaster assistance property (sec. 179(e)).

<sup>62</sup> Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election



For taxable years beginning in 2011 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner.<sup>63</sup>

### **Description of Proposal**

The proposal extends the \$250,000 and \$800,000 amounts to taxable years beginning in 2009.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2008.

## **3. Five-year carryback of operating losses**

### **Present Law**

Under present law, a net operating loss (“NOL”) generally means the amount by which a taxpayer’s business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.<sup>64</sup> NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.<sup>65</sup>

The alternative minimum tax rules provide that a taxpayer’s NOL deduction cannot reduce the taxpayer’s alternative minimum taxable income (“AMTI”) by more than 90 percent of the AMTI.

Different rules apply with respect to NOLs arising in certain circumstances. A three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback applies to NOLs (1) arising from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area), (2) certain

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under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

<sup>63</sup> Sec. 179(c)(2).

<sup>64</sup> Sec. 172(b)(1)(A).

<sup>65</sup> Sec. 172(b)(2).

amounts related to Hurricane Katrina, Gulf Opportunity Zone, and Midwestern Disaster Area, or (3) qualified disaster losses.<sup>66</sup> Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction). Additionally, a special rule applies to certain electric utility companies.

In the case of a life insurance company, present law allows a deduction for the taxable year for operations loss carryovers and carrybacks in lieu of the deduction for net operating losses allowed to other corporations.<sup>67</sup> A life insurance company is permitted to treat a loss from operations (as defined under section 810(c)) for any taxable year as an operations loss carryback to each of the three taxable years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.<sup>68</sup> Special rules apply to new life insurance companies.

### **Description of Proposal**

The proposal increases the general NOL carryback period from two years to five years in the case of an NOL for any taxable year ending during 2008 or 2009. The proposal also suspends the 90-percent limitation on the use of any alternative tax NOL deduction attributable to carrybacks from taxable years ending during 2008 or 2009, and carryovers to taxable years ending during 2008 and 2009.

A taxpayer may elect to have the carryback period determined without regard to the special five year period or may use any whole number of years less than five in its place. For example, a taxpayer incurring a net operating loss in 2008 may elect to carry the loss back to 2004 (i.e., four years).

For life insurance companies, the proposal increases the carryback period for losses from operations from three years to any whole amount of years less than six in the case of losses from operations for any taxable year ending during 2008 or 2009.

For a net operating loss for a taxable year ending during 2008, the proposal includes three transition rules: (1) any election to waive the carryback period under either sections 172(b)(3) or 810(b)(3) with respect to such loss may be revoked before the applicable date; (2) any election to disregard the five year carryback period in favor of a shorter carryback period under section 172(k) or to use a carryback period under section 810(b)(4) with respect to such loss is treated as timely made if made before the applicable date; and (3) any application for a tentative carryback adjustment under section 6411(a) with respect to such loss is treated as timely filed if filed before the applicable date. For purposes of the transition rules, the applicable date is the date which is 60 days after the date of the enactment of the proposal.

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<sup>66</sup> Sec. 172(b)(1)(J).

<sup>67</sup> Secs. 810, 805(a)(5).

<sup>68</sup> Sec. 810(b)(1).

The proposal does not apply to: (1) any taxpayer if (a) the Federal Government acquires, at any time, an equity interest in the taxpayer pursuant to the Emergency Economic Stabilization Act of 2008, or (b) the Federal Government acquires, at any time, any warrant (or other right) to acquire any equity interest with respect to the taxpayer pursuant to such Act; (2) the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation; and (3) any taxpayer that in 2008 or 2009 is a member of the same affiliated group (as defined in section 1504 without regard to subsection (b) thereof) as a taxpayer to which the proposal does not otherwise apply.

### **Effective Date**

The proposal is generally effective for net operating losses arising in taxable years ending after December 31, 2007. The modification to the alternative tax NOL deduction applies to taxable years ending after 1997. The modification with respect to operating loss deductions of life insurance companies applies to losses from operations arising in taxable years ending after December 31, 2007.

## **4. Modification of work opportunity tax credit**

### **Present Law**

#### **In general**

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

#### **Targeted groups eligible for the credit**

Generally an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

##### **(1) Families receiving TANF**

An eligible recipient is an individual certified by a designated local employment agency (e.g., a State employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program (“TANF”) for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

## (2) Qualified veteran

There are two subcategories of qualified veterans related to eligibility for Food stamps and compensation for a service-connected disability.

### Food stamps

A qualified veteran is a veteran who is certified by the designated local agency as a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

### Entitled to compensation for a service-connected disability

A qualified veteran also includes an individual who is certified as entitled to compensation for a service-connected disability and: (1) having a hiring date which is not more than one year after having been discharged or released from active duty in the Armed Forces of the United States, or (2) having been unemployed for six months or more (whether or not consecutive) during the one-year period ending on the date of hiring.

### Definitions

For these purposes, being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S. Code, which means having a disability rating of 10-percent or higher for service connected injuries.

For these purposes, a veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

## (3) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, and (2) having a hiring date within one year of release from prison or the date of conviction.

## (4) Designated community residents

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community or a rural renewal community.

For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget) which had a net population loss during the five-year periods 1990-1994 and 1995-1999. Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community or a rural renewal community.

(5) Vocational rehabilitation referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code; or (c) an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified summer youth employee

A qualified summer youth employee is an individual: (a) who performs services during any 90-day period between May 1 and September 15, (b) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date, (c) who has not been an employee of that employer before, and (d) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community (as defined under Subchapter U of Subtitle A, Chapter 1 of the Internal Revenue Code). As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified food stamp recipient

A qualified food stamp recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

#### (8) Qualified SSI recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income (“SSI”) benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

#### (9) Long-term family assistance recipients

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (a) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (b) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)<sup>69</sup> if the individual is hired within two years after the date that the 18-month total is reached; or (c) a member of a family who is no longer eligible for family assistance because of either Federal or State time limits, if the individual is hired within two years after the Federal or State time limits made the family ineligible for family assistance.

#### **Qualified wages**

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer’s deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally, wages are defined by reference to the FUTA definition of wages contained in section 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

#### **Calculation of the credit**

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year

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<sup>69</sup> The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006, for qualified individuals who begin to work for an employer after December 31, 2006.

wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

In the case of a qualified veteran who is entitled to compensation for a service connected disability, the credit equals 40 percent of \$12,000 of qualified first-year wages. This expanded definition of qualified first-year wages does not apply to the veterans qualified with reference to a food stamp program, as defined under present law.

### **Certification rules**

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

### **Minimum employment period**

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

### **Other rules**

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

### **Expiration**

The work opportunity tax credit is not available for individuals who begin work for an employer after August 31, 2011.

## **Description of Proposal**

The proposal creates a new targeted group for the work opportunity tax credit. That new category is unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010.

An unemployed veteran is defined as an individual certified by the designated local agency as someone who: (1) has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability; (2) has been discharged or released from active duty in the Armed Forces during 2008, 2009, or 2010; and (3) has received unemployment compensation under State or Federal law for not less than four weeks during the one-year period ending on the hiring date.

A disconnected youth is defined as an individual certified by the designated local agency as someone: (1) at least age 16 but not yet age 25 on the hiring date; (2) not regularly attending any secondary, technical, or post-secondary school during the six-month period preceding the hiring date; (3) not regularly employed during the six-month period preceding the hiring date; and (4) not readily employable by reason of lacking a sufficient number of skills.

## **Effective Date**

The proposals are effective for individuals who begin work for an employer after December 31, 2008.

## **5. Extension of election to accelerate AMT and research credits in lieu of bonus depreciation**

### **Present Law**

Corporations otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for “eligible qualified property” placed in service after March 31, 2008.<sup>70</sup> A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits.<sup>71</sup> The increases in the allowable credits are treated as refundable for purposes of this proposal. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this proposal.

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<sup>70</sup> In the case of an electing corporation that is a partner in a partnership, the corporate partner’s distributive share of partnership items is determined as if section 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property.

<sup>71</sup> Special rules apply to an applicable partnership.



The research credit or minimum tax credit limitation is increased by the bonus depreciation amount, which is equal to 20 percent of bonus depreciation<sup>72</sup> for certain eligible qualified property that could be claimed absent an election under this proposal. Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after March 31, 2008; (2) the taxpayer must purchase the property either (a) after March 31, 2008, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before April 1, 2008,<sup>73</sup> or (b) pursuant to a binding written contract which was entered into after March 31, 2008, and before January 1, 2009;<sup>74</sup> and (3) the property must be placed in service after March 31, 2008, and before January 1, 2009 (January 1, 2010 for certain longer-lived and transportation property).

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

### **Description of Proposal**

The proposal generally permits corporations to increase the research credit or minimum tax credit limitation by the bonus depreciation amount with respect to certain property placed in service in 2009 (2010 in the case of certain longer-lived and transportation property).

The proposal applies with respect to extension property, which is defined as property that is eligible qualified property solely because it meets the requirements under the extension of the special allowance for certain property acquired during 2009.<sup>75</sup>

The proposal allows a taxpayer that has made an election to increase the research credit or minimum tax credit limitation for its first taxable year ending after March 31, 2008, to have that election not apply to extension property. Further, the proposal allows a taxpayer that has not

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<sup>72</sup> For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation for all eligible qualified property determined if section 168(k)(1) applied using the most accelerated depreciation method (determined without regard to this proposal), and shortest life allowable for each property, and (ii) the amount of depreciation that would be determined if section 168(k)(1) did not apply using the same method and life for each property.

<sup>73</sup> In the case of passenger aircraft, the written binding contract limitation does not apply.

<sup>74</sup> Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

<sup>75</sup> The additional first year depreciation under section 168(k) is extended to certain property placed in service in 2009 in another proposal contained in the Chairman's Mark.

made an election for its first taxable year ending after March 31, 2008, to elect under this proposal for extension property for its first taxable year ending after December 31, 2008. In the case of a taxpayer electing to increase the research or minimum tax credit for both eligible qualified property and extension property, separate maximum increase amounts are applied to these two groups of property.

### **Effective Date**

The proposal is effective for taxable years ending after December 31, 2008.

## **6. Deferral of certain income from the discharge of indebtedness**

### **Present Law**

In general, gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness.<sup>76</sup> In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally are required to reduce certain tax attributes, including net operating losses, general business credits, minimum tax credits, capital loss carryovers, and basis in property, by the amount of the discharge of indebtedness.<sup>77</sup>

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.<sup>78</sup>

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange). Similarly, if a debtor repurchases its debt instrument for an amount that is less than the "adjusted issue price" of such debt instrument, the debtor realizes income equal to the excess of the adjusted issue price over the repurchase price.<sup>79</sup> In addition, indebtedness acquired

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<sup>76</sup> See sections 61(a)(12) and 108; but see sec. 102 (a debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor).

<sup>77</sup> Sec. 108(b).

<sup>78</sup> Sec. 1017.

<sup>79</sup> Treas. Reg. sec. 1.61-12(c)(2)(ii). Treas. Reg. sec. 1.1275-1(b) defines "adjusted issue price."

by a person who bears a relationship to the debtor described in section 267(b) or section 707(b) is treated as if it were acquired by the debtor.<sup>80</sup> Thus, where a debtor's indebtedness is acquired for less than its adjusted issue price by a person related to the debtor (within the meaning of section 267(b) or 707(b)), the debtor recognizes income from the cancellation of indebtedness.

### **Description of Proposal**

The proposal permits a taxpayer to elect to defer income from cancellation of indebtedness recognized by the taxpayer as a result of a repurchase by (1) the taxpayer or (2) a person who bears a relationship to the taxpayer described in section 267(b) or section 707(b), of a "debt instrument" that was issued by the taxpayer. The proposal applies only to repurchases of debt that (1) occur after December 31, 2008, and prior to January 1, 2011, and (2) are repurchases for cash. Thus, for example, the proposal does not apply to a debt-for-debt exchange or to any exchange of the taxpayer's equity for a debt instrument of the taxpayer. For purposes of the proposal, a "debt instrument" is broadly defined to include any bond, debenture, note, certificate or any other instrument or contractual arrangement constituting indebtedness.

A taxpayer electing to defer cancellation of debt from income under the proposal is required to include in income an amount equal to 25 percent of the deferred amount in each of the four taxable years beginning in the year following the year of the repurchase.

### **Effective Date**

The proposal is effective for repurchases after December 31, 2008.

## **7. Qualified small business stock**

### **Present Law**

Under present law, individuals may exclude 50-percent (60-percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The taxable portion of the gain is taxed at a maximum rate of 28 percent. Seven percent (forty-two percent after 2010) of the excluded gain is an alternative minimum tax preference. The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

### **Description of Proposal**

Under the proposal, the percentage exclusion for qualified small business stock sold by an individual is increased to 75 percent for stock issued after the date of enactment and before January 1, 2011.

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<sup>80</sup> Sec. 108(e)(4).

**Effective Date**

The provision is effective for stock issued after the date of enactment.

## **IV. MANUFACTURING RECOVERY PROVISIONS**

### **1. Expand industrial development bonds to include creation of intangible property and other modifications**

#### **Present Law**

Qualified small issue bonds (commonly referred to as “industrial development bonds” or “small issue IDBs”) are tax-exempt bonds issued by State and local governments to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than \$1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this \$1 million limit may be increased to \$10 million if, in addition to outstanding bonds, all other capital expenditures of the business (including related parties) in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to \$40 million per borrower (including related parties) regardless of where the property is located.

For bonds issued after September 30, 2009, the Code permits up to \$10 million of capital expenditures to be disregarded, in effect increasing from \$10 million to \$20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county. However, no more than \$10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other limits (e.g., the \$40 million per borrower limit) also continue to apply.

A manufacturing facility is any facility which is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property). Manufacturing facilities include facilities that are directly related and ancillary to a manufacturing facility (as described in the previous sentence) if (1) such facilities are located on the same site as the manufacturing facility and (2) not more than 25 percent of the net proceeds of the issue are used to provide such facilities.<sup>81</sup>

#### **Description of Proposal**

The proposal expands the definition of manufacturing facilities to mean any facility that is used in the manufacturing, creation, or production of tangible property or intangible property

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<sup>81</sup> The 25 percent restriction was enacted by the Technical and Miscellaneous Tax Act of 1988 because of concern over the scope of the definition of manufacturing facility. See H.R. Rpt. No. 100-795 (1988). The amendment was intended to clarify that while the manufacturing facility definition does not preclude the financing of ancillary activities, the 25 percent restriction was intended to limit the use of bond proceeds to finance facilities other than for “core manufacturing.”

(within the meaning of section 197(d)(1)(C)(iii)). For this purpose, intangible property means any patent, copyright, formula, process, design, knowhow, format, or other similar item.

In addition, the proposal provides that facilities that are functionally related and subordinate to the manufacturing facility are treated as a manufacturing facility and the 25 percent of net proceeds restriction does not apply to such facilities. Functionally related and subordinate facilities must be located on the same site as the manufacturing facility.

The proposal is effective for bonds issued after the date of enactment and before January 1, 2011.

### **Effective Date**

The proposal is effective for bonds issued after the date of enactment.

## **2. Credit for investment in advanced energy property**

### **Present Law**

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.<sup>82</sup> Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources.

An income tax credit is also allowed for certain energy property placed in service. Qualifying property includes certain fuel cell property, solar property, geothermal power production property, small wind energy property, combined heat and power system property, and geothermal heat pump property.<sup>83</sup>

In addition to these, numerous other credits are available to taxpayers to encourage renewable energy production and energy conservation, including, among others, credits for certain biofuels, plug-in electric vehicles, and energy efficient appliances, and for improvements to heating, air conditioning, and insulation.

No credit is specifically designed under present law to encourage the development of a domestic manufacturing base to support the industries described above.

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<sup>82</sup> Sec. 45. In addition to the electricity production credit, section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

<sup>83</sup> Sec. 48.

## **Description of Proposal**

The proposal establishes a 30 percent credit for investment in qualified property used in a qualified advanced energy manufacturing project. A qualified advanced energy manufacturing project is a project that re-equips, expands, or establishes a manufacturing facility for the production of property: (1) designed to be used to produce energy from the sun, wind, or geothermal deposits (within the meaning of section 613(e)(2)); (2) designed to manufacture fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) designed to manufacture electric grids to support the transmission of intermittent sources of renewable energy; or (4) designed to manufacture equipment for use for carbon capture or sequestration.

Qualified property must be depreciable (tangible) property used in a qualified advanced energy manufacturing project. The construction, reconstruction, or erection of such property must be completed by the taxpayer after October 31, 2008 (or, if purchased, the original use<sup>84</sup> of the property must commence with the taxpayer after such date). Qualified property does not include property designed to manufacture equipment for use in the refining or blending of any transportation fuel. The basis of qualified property must be reduced by the amount of credit received.

Credits are available only for qualified advanced energy manufacturing projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. The Secretary of Treasury must establish a certification program no later than 180 days after date of enactment, and may allocate up to \$2 billion in credits. Each project application must be submitted during the three-year period beginning on the date such certification program is established. An applicant for certification has two years from the date the Secretary accepts the application to provide the Secretary with evidence that the requirements for certification have been met. Upon certification, the applicant has five years from the date of issuance of the certification to place the project in service.

## **Effective Date**

The proposal is effective on date of enactment.

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<sup>84</sup> The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

## V. ECONOMIC RECOVERY TOOLS

### 1. Recovery Zone Bonds

#### Present Law

##### In general

Under present law, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) and other Code requirements are met.

##### Private activity bonds

The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test (“the private business test”); or (2) “the private loan financing test.”<sup>85</sup>

##### Private business test

Under the private business test, a bond is a private activity bond if it is part of an issue in which:

1. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit (“private business use”); and
2. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use (“private payment test”).<sup>86</sup>

A bond is not a private activity bond unless both parts of the private business test (i.e., the private business use test and the private payment test) are met. Thus, a facility that is 100

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<sup>85</sup> Sec. 141.

<sup>86</sup> The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.



percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not paid by the factory owner or other private parties and such bonds are not secured by the property.

#### Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of \$5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (e.g., personal) uses and payments to private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

#### Arbitrage restrictions

The exclusion from income for interest on State and local bonds does not apply to any arbitrage bond.<sup>87</sup> An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.<sup>88</sup> In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

#### **Qualified private activity bonds**

Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans’ mortgage, small issue, redevelopment, 501(c)(3), or student loan bond (sec. 141(e)).

The definition of an exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

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<sup>87</sup> Sec. 103(a) and (b)(2).

<sup>88</sup> Sec. 148.

In most cases, the aggregate volume of qualified private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State (“State volume cap”). For calendar year 2007, the State volume cap, which is indexed for inflation, equals \$85 per resident of the State, or \$256.24 million, if greater. Exceptions to the State volume cap are provided for bonds for certain governmentally owned facilities (e.g., airports, ports, high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (e.g., public/private educational facility bonds, enterprise zone facility bonds, qualified green building bonds, and qualified highway or surface freight transfer facility bonds).

Qualified private activity bonds generally are subject to restrictions on the use of proceeds for the acquisition of land and existing property. In addition, qualified private activity bonds generally are subject to restrictions on the use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores), and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Small issue and redevelopment bonds also are subject to additional restrictions on the use of proceeds for certain facilities (e.g., golf courses and massage parlors).

Moreover, the term of qualified private activity bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds.

### **Qualified tax credit bonds**

In lieu of interest, holders of qualified tax credit bonds receive a tax credit that accrues quarterly. The following bonds are qualified tax credit bonds: qualified forestry conservation bonds, new clean renewable energy bonds, qualified energy conservation bonds, and qualified zone academy bonds.<sup>89</sup>

Section 54A of the Code sets forth general rules applicable to qualified tax credit bonds. These rules include requirements regarding the expenditure of available project proceeds, reporting, arbitrage, maturity limitations, and financial conflicts of interest, among other special rules.

A taxpayer who holds a qualified tax credit bond on one or more credit allowance dates of the bond during the taxable year shall be allowed a credit against the taxpayer’s income tax for the taxable year. In general, the credit amount for any credit allowance date is 25 percent of the annual credit determined with respect to the bond. The annual credit is determined by multiplying the applicable credit rate by the outstanding face amount of the bond. The applicable credit rate for the bond is the rate that the Secretary estimates will permit the issuance of the qualified tax credit bond with a specified maturity or redemption date without discount and

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<sup>89</sup> See secs. 54B, 54C, 54D, and 54E.

without interest cost to the qualified issuer.<sup>90</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings.

The credit is included in gross income and, under regulations prescribed by the Secretary, may be stripped.<sup>91</sup>

Section 54A of the Code requires that 100 percent of the available project proceeds of qualified tax credit bonds must be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as qualified tax credit bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified tax credit bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified tax credit bonds are issued.

The maturity of qualified tax credit bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified tax credit bonds are issued.

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<sup>90</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

<sup>91</sup> "Stripped" means a separation (including at issuance) of the ownership of a qualified tax credit bond from the entitlement to the credit with respect to such bond.

## **Description of Proposal**

### **In general**

The proposal permits an issuer to designate one or more areas as recovery zones. The area must have significant poverty, unemployment, or rate of home foreclosures, or be any area for which a designation as an empowerment zone or renewal community is in effect. Issuers may issue recovery zone economic development bonds and recovery zone facility bonds with respect to these zones.

There is a national recovery zone economic development bond limitation of \$10 billion. In addition, there is a separate national recovery zone facility bond limitation of \$15 billion. The Secretary is to separately allocate the bond limitations among the States in the proportion that each State's employment decline bears to the aggregate 2008 State employment declines for all States. In turn each State is to reallocate its allocation among the counties (parishes) and large municipalities in such State in the proportion that each such county or municipality's 2008 employment decline bears to the aggregate employment declines for all counties and municipalities in such State. In calculating the local employment decline with respect to a county, the portion of such decline attributable to a large municipality is disregarded for purposes of determining the county's portion of the State employment decline and is attributable to the large municipality only.

In making allocations to the States, the Secretary shall ensure that the minimum allocation for each State does not fall below two percent of the respective national bond limitation.

For purposes of the proposal "2008 State employment decline" means, with respect to any State, the excess (if any) of (i) the number of individuals employed in such State as determined for December 2007, over (ii) the number of individuals employed in such State as determined for December 2008. The term "large municipality" means a municipality with a population of more than 100,000.

### **Recovery Zone Economic Development Bonds**

New section 54AA(h) of the proposal creates a special rule for qualified bonds (a type of taxable governmental bond) issued before January 1, 2011, that entitles the issuer of such bonds to receive an advance tax credit equal to 35 percent of the interest payable on an interest payment date.<sup>92</sup> For taxable governmental bonds that are designated recovery zone economic development bonds, the applicable percentage is 40 percent.

A recovery zone economic development bond is a taxable governmental bond issued as part of an issue if 100 percent of the available project proceeds of such issue are to be used for one or more qualified economic development purposes and the issuer designates such bond for purposes of this section. A qualified economic development purpose means expenditures for

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<sup>92</sup> See "Build America Bonds" discussed below.

purposes of promoting development or other economic activity in a recovery zone, including (1) capital expenditures paid or incurred with respect to property located in such zone, (2) expenditures for public infrastructure and construction of public facilities located in a recovery zone.

The aggregate face amount of bonds which may be designated by any issuer cannot exceed the amount of the recovery zone economic development bond limitation allocated to such issuer.

### **Recovery Zone Facility Bonds**

The proposal creates a new category of exempt facility bonds, “recovery zone facility bonds.” A recovery zone facility bond means any bond issued as part of an issue if: (1) 95 percent or more of the net proceeds of such issue are to be used for recovery zone property and (2) such bond is issued before January 1, 2011, and (3) the issuer designates such bond as a recovery zone facility bond. The aggregate face amount of bonds which may be designated by any issuer cannot exceed the amount of the recovery zone facility bond limitation allocated to such issuer.

Under the proposal, the term “recovery zone property” means any property subject to depreciation to which section 168 applies (or would apply but for section 179) if (1) such property was acquired by the taxpayer by purchase after the date on which the designation of the recovery zone took effect; (2) the original use of such property in the recovery zone commences with the taxpayer; and (3) substantially all of the use of such property is in the recovery zone and is in the active conduct of a qualified business by the taxpayer in such zone. The term “qualified business” means any trade or business except that the rental to others of real property located in a recovery zone shall be treated as a qualified business only if the property is not residential rental property (as defined in section 168(e)(2)) and does not include any trade or business consisting of the operation of any facility described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale of alcoholic beverages for consumption off premises).

Subject to the following exceptions and modifications, issuance of recovery zone facility bonds is subject to the general rules applicable to issuance of qualified private activity bonds:

1. Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);
2. The restriction on acquisition of existing property does not apply (sec. 147(d));

### **Effective Date**

The proposal is effective for obligations issued after the date of enactment.

## **2. Tribal Economic Development Bonds**

### **Present Law**

Under present law, gross income does not include interest on State or local bonds.<sup>93</sup> State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For these purposes, the term “nongovernmental person” includes the Federal government and all other individuals and entities other than States or local governments.<sup>94</sup> Interest on private activity bonds is taxable, unless the bonds are issued for certain purposes permitted by the Code and other requirements are met.<sup>95</sup>

Although not States or subdivisions of States, Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.<sup>96</sup> Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. Under section 7871(c), tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions.<sup>97</sup> The term essential governmental function does not include any function that is not customarily performed by State and local governments with general taxing powers. Section 7871(c) further prohibits Indian tribal governments from issuing tax-exempt private activity bonds (as defined in section 141(a) of the Code) with the exception of certain bonds for manufacturing facilities.

### **Description of Proposal**

#### **Tribal Economic Development Bonds**

The proposal allows Indian tribal governments to issue “tribal economic development bonds.” There is a national bond limitation of \$2 billion, to be allocated as the Secretary determines appropriate, in consultation with the Secretary of the Interior. Tribal economic development bonds issued by an Indian tribal government are treated as if such bond were issued by a State except that section 146 (relating to State volume limitations) does not apply.

A tribal economic development bond is any bond issued by an Indian tribal government (1) the interest on which would be tax-exempt if issued by a State or local government but would

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<sup>93</sup> Sec. 103.

<sup>94</sup> Sec. 141(b)(6); Treas. Reg. sec. 1.141-1(b).

<sup>95</sup> Secs. 103(b)(1) and 141.

<sup>96</sup> Sec. 7871.

<sup>97</sup> Sec. 7871(c).

be taxable under section 7871(c), and (2) that is designated by the Indian tribal government as a tribal economic development bond. The aggregate face amount of bonds that may be designated by any Indian tribal government cannot exceed the amount of national tribal economic development bond limitation allocated to such government.

Tribal economic development bonds cannot be used to finance any portion of a building in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted, or housed, or any other property used in the conduct of such gaming. Nor can tribal economic development bonds be used to finance any facility located outside of the Indian reservation.

### **Treasury Study**

The proposal requires that the Treasury Department study the effects of tribal economic development bonds. One year after the date of enactment, a report is to be submitted to Congress providing the results of such study along with any recommendations, including whether the restrictions of section 7871(c) should be eliminated or otherwise modified.

### **Effective Date**

The proposal applies to obligations issued after the date of enactment.

## **3. Extend and modify the new markets tax credit**

### **Present Law**

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (“CDE”).<sup>98</sup> The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if, at any time during the seven-year period that begins on the date of the original issue of the qualified equity investment, the issuing entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by providing them with

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<sup>98</sup> Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (2000).

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

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

The Secretary has the authority to designate “targeted populations” as low-income communities for purposes of the new markets tax credit. For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. sec. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.<sup>99</sup> Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is

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<sup>99</sup> 12 U.S.C. sec. 4702(17) (defines “low-income” for purposes of 12 U.S.C. sec. 4702(20)).



used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at \$3.5 billion per year for calendar years 2006 through 2009. Lower caps applied for calendar years 2001 through 2005.

### **Description of Proposal**

For calendar years 2008 and 2009, the proposal increases the maximum amount of qualified equity investments by \$1.5 billion (to \$5 billion for each year). The proposal requires that the additional amount for 2008 be allocated to qualified CDEs that submitted an allocation application with respect to calendar year 2008 and either (1) did not receive an allocation for such calendar year, or (2) received an allocation for such calendar year in an amount less than the amount requested in the allocation application. The proposal also provides alternative minimum tax relief for equity investment allocations subject to the 2009 annual limitation.

### **Effective Date**

The proposal is effective for taxable years ending after the date of enactment and to carrybacks of such credits.

## VI. INFRASTRUCTURE FINANCING TOOLS

### 1. De minimis safe harbor exception for tax-exempt interest expense of financial institutions and modification of small issuer exception to tax-exempt interest expense allocation rules for financial institutions

#### Present Law

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.<sup>100</sup> In general, an interest deduction is disallowed only if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.<sup>101</sup>

#### Two-percent rule for individuals and certain nonfinancial corporations

In the absence of direct evidence linking an individual taxpayer's indebtedness with the purchase or carrying of tax-exempt obligations, the Internal Revenue Service takes the position that it ordinarily will not infer that a taxpayer's purpose in borrowing money was to purchase or carry tax-exempt obligations if the taxpayer's investment in tax-exempt obligations is "insubstantial."<sup>102</sup> An individual's holdings of tax-exempt obligations are presumed to be insubstantial if during the taxable year the average adjusted basis of the individual's tax-exempt obligations is two percent or less of the average adjusted basis of the individual's portfolio investments and assets held by the individual in the active conduct of a trade or business.

Similarly, in the case of a corporation that is not a financial institution or a dealer in tax-exempt obligations, where there is no direct evidence of a purpose to purchase or carry tax-exempt obligations, the corporation's holdings of tax-exempt obligations are presumed to be insubstantial if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held by the corporation in the active conduct of its trade or business.

#### Financial institutions

In the case of a financial institution, the Code generally disallows that portion of the taxpayer's interest expense that is allocable to tax-exempt interest.<sup>103</sup> The amount of interest that is disallowed is an amount which bears the same ratio to such interest expense as the taxpayer's

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<sup>100</sup> Sec. 265(a).

<sup>101</sup> See Rev. Proc. 72-18, 1972-1 C.B. 740.

<sup>102</sup> Id.

<sup>103</sup> Sec. 265(b)(1). A "financial institution" is any person that (1) accepts deposits from the public in the ordinary course of such person's trade or business and is subject to Federal or State supervision as a financial institution or (2) is a corporation described in section 585(a)(2). Sec. 265(b)(5).

average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to the average adjusted bases for all assets of the taxpayer.

#### Exception for certain obligations of qualified small issuers

The general rule in section 265(b), denying financial institutions' interest expense deductions allocable to tax-exempt obligations, does not apply to "qualified tax-exempt obligations."<sup>104</sup> Instead, as discussed in the next section, only 20 percent of the interest expense allocable to "qualified tax-exempt obligations" is disallowed.<sup>105</sup> A "qualified tax-exempt obligation" is a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond, and (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b).

A "qualified small issuer" is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be \$10 million or less.<sup>106</sup> The Code specifies the circumstances under which an issuer and all subordinate entities are aggregated.<sup>107</sup> For purposes of the \$10 million limitation, an issuer and all entities that issue obligations on behalf of such issuer are treated as one issuer. All obligations issued by a subordinate entity are treated as being issued by the entity to which it is subordinate. An entity formed (or availed of) to avoid the \$10 million limitation and all entities benefiting from the device are treated as one issuer.

Composite issues (i.e., combined issues of bonds for different entities) qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).<sup>108</sup> Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed \$10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than \$10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

#### Treatment of financial institution preference items

Section 291(a)(3) reduces by 20 percent the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to carry tax-exempt obligations acquired after December 31, 1982, and before

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<sup>104</sup> Sec. 265(b)(3).

<sup>105</sup> Secs. 265(b)(3)(A), 291(a)(3) and 291(e)(1).

<sup>106</sup> Sec. 265(b)(3)(C).

<sup>107</sup> Sec. 265(b)(3)(E).

<sup>108</sup> Sec. 265(b)(3)(F).

August 8, 1986.<sup>109</sup> Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20 percent.

### **Description of Proposal**

#### **Two-percent safe harbor for financial institutions**

The proposal provides that tax-exempt obligations issued during 2009 or 2010 and held by a financial institution, in an amount not to exceed two percent of the adjusted basis of the financial institution's assets, are not taken into account for the purpose of determining the portion of the financial institution's interest expense subject to the pro rata interest disallowance rule of section 265(b). For purposes of this rule, a refunding bond (whether a current or advance refunding) is treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond).

The proposal also amends section 291(e) to provide that tax-exempt obligations issued during 2009 and 2010, and not taken into account for purposes of the calculation of a financial institution's interest expense subject to the pro rata interest disallowance rule, are treated as having been acquired on August 7, 1986. As a result, such obligations are financial institution preference items, and the amount allowable as a deduction by a financial institution with respect to interest incurred to carry such obligations is reduced by 20 percent.

#### **Modifications to qualified small issuer exception**

With respect to tax-exempt obligations issued during 2009 and 2010, the proposal increases from \$10 million to \$30 million the annual limit for qualified small issuers.

In addition, in the case of "qualified financing issue" issued in 2009 or 2010, the proposal applies the \$30 million annual volume limitation at the borrower level (rather than at the level of the pooled financing issuer). Thus, for the purpose of applying the requirements of the section 265(b)(3) qualified small issuer exception, the portion of the proceeds of a qualified financing issue that are loaned to a "qualified borrower" that participates in the issue are treated as a separate issue with respect to which the qualified borrower is deemed to be the issuer.

A "qualified financing issue" is any composite, pooled or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers all of whom are qualified borrowers. A "qualified borrower" means (1) a State or political subdivision of a State or (2) an organization described in section 501(c)(3) and exempt from tax under section 501(a). Thus, for example, a \$100 million pooled financing issue that was issued in 2009 could qualify for the section 265(b)(3) exception if the proceeds of such issue were used to make four equal loans of \$25 million to four qualified borrowers. However, if (1) more than \$30 million were loaned to any qualified borrower, (2) any borrower were not a

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<sup>109</sup> Sec. 291(e)(1).

qualified borrower, or (3) any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to such borrower, fail to meet any of the other requirements of section 265(b)(3), the entire \$100 million pooled financing issue would fail to qualify for the exception.

For purposes of determining whether an issuer meets the requirements of the small issuer exception, qualified 501(c)(3) bonds issued in 2009 or 2010 are treated as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds). In addition, in the case of an organization described in section 501(c)(3) and exempt from taxation under section 501(a), requirements for “qualified financing issues” shall be applied as if the section 501(c)(3) organization were the issuer. Thus, in any event, an organization described in section 501(c)(3) and exempt from taxation under section 501(a) shall be limited to the \$30 million per issuer cap for qualified tax exempt obligations described in section 265(b)(3).

#### **Effective Date**

The proposals are effective for obligations issued after December 31, 2008.

## **2. Repeal of alternative minimum tax limitations on tax exempt bonds issued in 2009 and 2010**

#### **Present Law**

Present law imposes an alternative minimum tax (“AMT”) on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. The tentative minimum tax is computed based upon a taxpayer’s alternative minimum taxable income (“AMTI”). AMTI is the taxpayer’s taxable income modified to take into account certain preferences and adjustments. One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (sec. 57(a)(5)). Also, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of items, including tax-exempt interest, that are excluded from taxable income but included in the corporation’s earnings and profits (sec. 56(g)(4)(B)).

#### **Description of Proposal**

The proposal provides that tax-exempt interest on private activity bonds issued in 2009 and 2010 is not an item of tax preference for purposes of the alternative minimum tax and interest on tax exempt bonds issued in 2009 and 2010 is not included in the corporate adjustment based on current earnings. For these purposes, a refunding bond is treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond).

#### **Effective Date**

The proposal applies to interest on bonds issued after December 31, 2008.

### **3. One-year delay of withholding on government contractors**

#### **Present law**

For payments made after December 31, 2010, the Code imposes a withholding requirement at a three-percent rate on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than \$100 million of annual expenditures for property or services that would otherwise be subject to withholding under this proposal are exempt from the withholding requirement.

Payments subject to the three-percent withholding requirement include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services. For example, payments to a commodity producer under a government commodity support program are subject to the withholding requirement. The proposal imposes information reporting requirements on the payments that are subject to withholding under the proposal.

The three-percent withholding requirement does not apply to any payments made through a Federal, State, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. The three-percent withholding requirement also does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. Although the proposal applies to payments that are potentially subject to backup withholding under section 3406, it does not apply to those payments from which amounts are actually being withheld under backup withholding rules.

The three-percent withholding requirement also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)), and payments to government employees that are not otherwise excludable from the new withholding proposal with respect to the employees' services as employees.

#### **Description of Proposal**

The proposal delays the implementation of the three percent withholding requirement by one year to apply to payments after December 31, 2011.

#### **Effective Date**

The proposal is effective on the date of enactment.

#### 4. Qualified school construction bonds

##### Present Law

##### Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. These can include tax-exempt bonds which finance public schools.<sup>110</sup> An issuer must file with the IRS certain information about the bonds issued in order for that bond issue to be tax-exempt.<sup>111</sup> Generally, this information return is required to be filed no later than the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds does not apply to any arbitrage bond.<sup>112</sup> An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.<sup>113</sup> In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

##### Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue “qualified zone academy bonds.”<sup>114</sup> A total of \$400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2009. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest

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<sup>110</sup> Sec. 103.

<sup>111</sup> Sec. 149(e).

<sup>112</sup> Sec. 103(a) and (b)(2).

<sup>113</sup> Sec. 148.

<sup>114</sup> Sec. 1397E.

payment on the bond), and may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.<sup>115</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the principal on the bond is 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

The arbitrage requirements which generally apply to interest-bearing tax-exempt bonds also generally apply to qualified zone academy bonds. In addition, an issuer of qualified zone academy bonds must reasonably expect to and actually spend 100 percent or more of the proceeds of such bonds on qualified zone academy property within the three years period that begins on the date of issuance. To the extent less than 100 percent of the proceeds are used to finance qualified zone academy property during the three years spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end of such three years period to redeem any nonqualified bonds. The three years spending period may be extended by the Secretary if the issuer establishes that the failure to meet the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence.

Two special arbitrage rules apply to qualified zone academy bonds. First, available project proceeds invested during the three-year period beginning on the date of issue are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). Available

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<sup>115</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.



project proceeds are proceeds from the sale of an issue of qualified zone academy bonds, less issuance costs (not to exceed two percent) and any investment earnings on such proceeds. Thus, available project proceeds invested during the three-year spending period may be invested at unrestricted yields, but the earnings on such investments must be spent on qualified zone academy property. Second, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified zone academy bonds are issued.

Issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

### **Description of Proposal**

#### **In general**

The proposal creates a new category of tax-credit bonds, qualified school construction bonds. Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond is issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

#### **National limitation**

There is a national limitation on qualified school construction bonds of \$5 billion for calendar years 2009 and 2010, respectively. Allocations of the national limitation of qualified school construction bonds are divided between the States and certain large school districts. The States receive 60 percent of the national limitation for a calendar year and the remaining 40 percent of the national limitation for a calendar year is allocated to certain of the largest school districts.

#### **Allocation to the States**

Generally allocations are made to the States under the 60 percent allocation according to their respective populations of children aged five through seventeen. However, the Secretary of the Treasury shall adjust the annual allocations among the States to ensure that for each State the sum of its allocations under the 60 percent allocation plus any allocations to large educational agencies within the States is not less than a minimum percentage. A State's minimum percentage for a calendar year is a product of 1.68 and the minimum percentage described in section 1124(d) of the Elementary and Secondary Education Act of 1965 for such State for the most recent fiscal year ending before such calendar year.

For allocation purposes, a State includes the District of Columbia and any possession of the United States. The proposal provides a special allocation for possessions of the United States other than Puerto Rico under the 60 percent share of the national limitation for States. Under this

special rule an allocation to a possession other than Puerto Rico is made on the basis of the respective populations of individuals below the poverty line (as defined by the Office of Management and Budget) rather than respective populations of children aged five through seventeen. This special allocation reduces the State allocation share of the national limitation otherwise available for allocation among the States. Under another special rule the Secretary of the Interior may allocate \$200 million of school construction bonds for 2009 and 2010, respectively to Indian schools. This special allocation for Indian schools is to be used for purposes of the construction, rehabilitation, and repair of schools funded by the Bureau of Indian Affairs. For purposes of such allocations Indian tribal governments are qualified issuers. The special allocation for Indian schools does not reduce the State allocation share of the national limitation otherwise available for allocation among the States.

If an amount allocated under this allocation to the States is unused for a calendar year it may be carried forward by the State to the next calendar year.

### **Allocation to large school districts**

The remaining 40 percent of the national limitation for a calendar year is allocated by the Secretary of the Treasury among local educational agencies which are large local educational agencies for such year. This allocation is made in proportion to the respective amounts each agency received for Basic Grants under subpart 2 of Part A of Title I of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year ending before such calendar year. Any unused allocation of any agency within a State may be allocated by the agency to such State. With respect to a calendar year, the term large local educational agency means: any local educational agency if such agency is: (1) among the 100 local educational agencies with the largest numbers of children aged 5 through 17 from families living below the poverty level, or (2) one of not more than 25 local educational agencies (other than in 1, immediately above) that the Secretary of Education determines are in particular need of assistance, based on a low level of resources for school construction, a high level of enrollment growth, or other such factors as the Secretary of Education deems appropriate. If any amount allocated to large local educational agency is unused for a calendar year the agency may reallocate such amount to the State in which the agency is located.

The proposal makes qualified school construction bonds a type of qualified tax credit bond for purposes of section 54A of the Code. In addition, qualified school construction bonds may be issued by Indian tribal governments only to the extent such bonds are issued for purposes that satisfy the present law requirements for tax-exempt bonds issued by Indian tribal governments (i.e., essential governmental functions and certain manufacturing purposes).

The proposal requires 100 percent of the available project proceeds of qualified school construction bonds to be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified purposes during the three-year spending period, bonds will continue to qualify as qualified school construction bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's

request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified school construction bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified school construction bonds are issued.

The maturity of qualified school construction bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified school construction bonds are issued.

As with present-law tax credit bonds, the taxpayer holding qualified school construction bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 100 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer. The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Issuers of qualified school construction bonds are required to certify that the financial disclosure requirements that applicable State and local law requirements governing conflicts of interest are satisfied with respect to such issue, as well as any other additional conflict of interest rules prescribed by the Secretary with respect to any Federal, State, or local government official directly involved with the issuance of qualified school construction bonds.

#### **Effective Date**

The proposal is effective for bonds issued after December 31, 2008.

### **5. Extend and expand qualified zone academy bonds**

#### **Present Law**

#### **Tax-exempt bonds**

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities

of these governmental units or if the bonds are repaid with revenues of the governmental units. These can include tax-exempt bonds which finance public schools.<sup>116</sup> An issuer must file with the IRS certain information about the bonds issued in order for that bond issue to be tax-exempt.<sup>117</sup> Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds does not apply to any arbitrage bond.<sup>118</sup> An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.<sup>119</sup> In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

### **Qualified zone academy bonds**

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue “qualified zone academy bonds.”<sup>120</sup> A total of \$400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2009. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includible in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer.<sup>121</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems

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<sup>116</sup> Sec. 103.

<sup>117</sup> Sec. 149(e).

<sup>118</sup> Sec. 103(a) and (b)(2).

<sup>119</sup> Sec. 148.

<sup>120</sup> Sec. 1397E.

<sup>121</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the principal on the bond is 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

The arbitrage requirements which generally apply to interest-bearing tax-exempt bonds also generally apply to qualified zone academy bonds. In addition, an issuer of qualified zone academy bonds must reasonably expect to and actually spend 100 percent or more of the proceeds of such bonds on qualified zone academy property within the three-year period that begins on the date of issuance. To the extent less than 100 percent of the proceeds are used to finance qualified zone academy property during the three-year spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem any nonqualified bonds. The three-year spending period may be extended by the Secretary if the issuer establishes that the failure to meet the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence.

Two special arbitrage rules apply to qualified zone academy bonds. First, available project proceeds invested during the three-year period beginning on the date of issue are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). Available project proceeds are proceeds from the sale of an issue of qualified zone academy bonds, less issuance costs (not to exceed two percent) and any investment earnings on such proceeds. Thus, available project proceeds invested during the three-year spending period may be invested at unrestricted yields, but the earnings on such investments must be spent on qualified zone academy property. Second, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified zone academy bonds are issued.

Issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

### **Description of Proposal**

The proposal extends and expands the present-law qualified zone academy bond program. The proposal authorizes issuance of up to \$1.4 billion of qualified zone academy bonds annually for 2009 and 2010, respectively.

### **Effective Date**

The proposal applies to bonds issued after December 31, 2008.

## **6. Build America Bonds**

### **Present Law**

#### **In general**

Under present law, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) and other Code requirements are met.

#### **Private activity bonds**

The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test (“the private business test”); or (2) “the private loan financing test.”<sup>122</sup>

##### **Private business test**

Under the private business test, a bond is a private activity bond if it is part of an issue in which:

1. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit (“private business use”); and

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<sup>122</sup> Sec. 141.

2. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use (“private payment test”).<sup>123</sup>

A bond is not a private activity bond unless both parts of the private business test (i.e., the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not paid by the factory owner or other private parties.

#### Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of \$5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

#### Arbitrage restrictions

The exclusion from income for interest on State and local bonds does not apply to any arbitrage bond.<sup>124</sup> An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.<sup>125</sup> In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

#### **Qualified tax credit bonds**

In lieu of interest, holders of qualified tax credit bonds receive a tax credit that accrues quarterly. The following bonds are qualified tax credit bonds: qualified forestry conservation

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<sup>123</sup> The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.

<sup>124</sup> Sec. 103(a) and (b)(2).

<sup>125</sup> Sec. 148.

bonds, new clean renewable energy bonds, qualified energy conservation bonds, and qualified zone academy bonds.<sup>126</sup>

Section 54A of the Code sets forth general rules applicable to qualified tax credit bonds. These rules include requirements regarding credit allowance dates, the expenditure of available project proceeds, reporting, arbitrage, maturity limitations, and financial conflicts of interest, among other special rules.

A taxpayer who holds a qualified tax credit bond on one or more credit allowance dates of the bond during the taxable year shall be allowed a credit against the taxpayer's income tax for the taxable year. In general, the credit amount for any credit allowance date is 25 percent of the annual credit determined with respect to the bond. The annual credit is determined by multiplying the applicable credit rate by the outstanding face amount of the bond. The applicable credit rate for the bond is the rate that the Secretary estimates will permit the issuance of the qualified tax credit bond with a specified maturity or redemption date without discount and without interest cost to the qualified issuer.<sup>127</sup> The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings.

The credit is included in gross income and, under regulations prescribed by the Secretary, may be stripped (a separation (including at issuance) of the ownership of a qualified tax credit bond and the entitlement to the credit with respect to such bond).

Section 54A of the Code requires that 100 percent of the available project proceeds of qualified tax credit bonds must be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as qualified tax credit bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified tax credit bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount

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<sup>126</sup> See secs. 54B, 54C, 54D, and 54E.

<sup>127</sup> Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.



necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified tax credit bonds are issued.

The maturity of qualified tax credit bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified tax credit bonds are issued.

## **Description of Proposal**

### **In general**

For bonds issued in 2009 through 2011, the proposal permits an issuer to elect to have an otherwise tax-exempt bond treated as a “taxable governmental bond.” A “taxable governmental bond” is any obligation (other than a private activity bond) if the interest on such obligation would be (but for this proposal) excludable from gross income under section 103 and the issuer makes an irrevocable election to have the proposal apply. In determining if an obligation would be tax-exempt under section 103, the credit (or the payment discussed below for qualified bonds) is not treated as a Federal guarantee. Further, the yield on a taxable governmental bond is determined without regard to the credit. A taxable governmental bond does not include any bond if the issue price has more than a de minimis amount of premium over the stated principal amount of the bond.

The holder of a taxable governmental bond will accrue a tax credit in the amount of 35 percent of the interest payable on the interest payment dates of the bond during the calendar year. The interest payment date is any date on which the holder of record of the taxable governmental bond is entitled to a payment of interest under such bond. The sum of the accrued credits is allowed against regular and alternative minimum tax. Unused credit may be carried forward to succeeding taxable years. The credit, as well as the interest paid by the issuer, is included in gross income and the credit may be stripped under rules similar to those provided in section 54A regarding qualified tax credit bonds. Rules similar to those that apply for S corporations, partnerships and regulated investment companies with respect to qualified tax credit bonds also apply to the credit.

### **Special rule for qualified bonds issued during 2009 and 2010**

A “qualified bond” is any taxable governmental bond issued as part of an issue if 100 percent of the available project proceeds of such issue are to be used for capital expenditures.<sup>128</sup>

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<sup>128</sup> Under Treas. Reg. sec. 150-1(b), capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under Treas. Reg. sec. 1.150-2(c)) under general Federal income tax principles. For purposes of applying the “general Federal income tax principles” standard, an issuer should generally be treated as if it were a corporation subject to taxation under subchapter C of chapter 1

The bond must be issued after the date of enactment of the proposal and before January 1, 2011. The issuer must make an irrevocable election to have the special rule for qualified bonds apply.

Under the special rule for qualified bonds, in lieu of the tax credit to the holder, the issuer is allowed a credit equal to 35 percent of each interest payment made under such bond. Under the proposal, the Secretary will pay to the issuer the amount of the credit accrued with respect to an interest payment date. The payment by the Secretary is to be made contemporaneously with the interest payment made by the issuer, and may be made either in advance or as reimbursement. In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer. For purposes of the arbitrage rules, the yield on a qualified bond is reduced by the amount of the credit/payment.

### **Transitional coordination with State law**

As noted above, interest on a taxable governmental bond and the related credit are includible in gross income to the holder for Federal tax purposes. The proposal provides that until a State provides otherwise, the interest on any taxable governmental bond and the amount of any credit determined with respect to such bond shall be treated as being exempt from Federal income tax for purposes of State income tax laws.

### **Effective Date**

The proposal is effective for obligations issued after the date of enactment.

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of the Code. An example of a capital expenditure would include expenditures made for the purchase of fiber-optic cable to provide municipal broadband service.

## VII. DESCRIPTION OF NONTAX ITEMS

### 1. Prohibition on collection of certain payments<sup>129</sup>

#### Present Law

The Continued Dumping and Subsidy Offset Act of 2000 (CDSOA) (19 U.S.C. 1675c), which was repealed in the Deficit Reduction Act of 2005 (Pub. L. No. 109-171), required U.S. Customs and Border Protection (CBP) to distribute certain duties collected on imports to U.S. companies that petitioned the U.S. Government for relief. From 2001 – 2005, CBP distributed these duties to eligible U.S. companies, including those companies that petitioned for relief from Mexican and Canadian imports.

In 2006, CBP stopped distributing duties collected on Mexican and Canadian imports on the grounds that the U.S. Court of International Trade (CIT) and the U.S. Court of Appeals for the Federal Circuit (CAFC) found that the CDSOA did not specifically apply to Canada and Mexico, and was therefore inconsistent with U.S. legislation implementing the North American Free Trade Agreement. The CIT and CAFC granted prospective relief, and specifically refused to opine on whether CBP should require repayment of, or otherwise recoup, duties collected on imports of Canadian and Mexican imports that were previously distributed.

In November 2008, CBP sent letters to several U.S. companies that received distributions of duties collected on Mexican and Canadian imports, demanding that the companies repay duties distributed between January 1, 2001, and January 1, 2006. CBP granted the companies an extension for repayment until March 28, 2009.

#### Description of Proposal

The proposal has four sections. First, it prohibits the Secretary of Homeland Security, or any other person, from requiring repayment of, or in any other way recouping, duties that were (1) distributed pursuant to the CDSOA; (2) assessed and paid on imports of goods from Canada and Mexico; and (3) distributed on or after January 1, 2001, and before January 1, 2006. Second, it prohibits CBP from offsetting any current or future duty distributions on goods from countries other than Canada and Mexico in an attempt to recoup duties described above. Third, the provision requires CBP to refund any such duty repayments or recoupments it has already received. Further, it requires CBP to fully distribute any duties it is withholding as an offset against current or future duty distributions. Fourth, the provision clarifies that CBP is not prohibited from collecting payments resulting from (1) false statements or other misconduct by a recipient of a duty payment or (2) re-liquidation of entries with respect to which duty payments were made.

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<sup>129</sup> Description of present law and the proposal were prepared by the majority staff of the Senate Committee on Finance.

## **2. Extension of trade adjustment assistance programs<sup>130</sup>**

### **Present Law**

The current TAA programs (19 U.S.C. 2271 et seq.) provide U.S. workers, firms, and farmers who are negatively impacted by trade with various forms of government-funded adjustment assistance.

Chapter 2 of the Trade Act of 1974 provides for the TAA for Workers Program. Workers who lose their jobs due to increased imports or shifts in production to certain countries, including those with a free trade agreement with the United States, are eligible to receive adjustment assistance such as career counseling; up to two years of training; income support during training; a health care tax credit; and job search and relocation allowances. Chapter 2 also provides for an Alternative TAA Program, which permits older workers (over 50 years old) for whom retraining may not be appropriate to accept reemployment at a lower wage and receive a wage subsidy.

Chapter 3 of the Trade Act of 1974 provides for a TAA for Firms Program. The TAA for Firms Program provides manufacturing firms that (1) separate, or may have to separate, a significant part of their workforce and (2) experience declining sales or production; as a result of import competition with financial and technical assistance to improve the manufacturer's competitiveness.

Chapter 4 of the Trade Act of 1974 provided for a TAA for Communities Program, which was terminated in 1982. The program provided assistance to distressed communities.

Chapter 6 of the Trade Act of 1974 establishes the TAA for Farmers program, which permits agricultural commodity producers to seek adjustment assistance if there has been (1) a 20% decline in the price for a commodity; (2) an increase in imports of that commodity; and (3) such increased imports contributed importantly to the decline in price. Once a commodity is certified by the Secretary of Agriculture, individual producers may qualify for benefits, which include technical assistance and cash payments. Authorization for the TAA for Farmers program expired on December 31, 2007, and has not been renewed.

The TAA for Workers and Firms programs expired on December 31, 2007; however, the Workers and Firms programs continue to operate under appropriations provided to the Departments of Labor and Commerce, respectively, under H.R. 2638, the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act, 2009 (Pub. L. 110-329).

### **Description of Proposal**

First, the proposal amends section 245(a) of the Trade Act of 1974 to extend the authorization for the TAA for Workers program until December 31, 2010. Second, the proposal amends section 246(b)(1) of the Trade Act of 1974 to extend the authorization for Alternative

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<sup>130</sup> Description of present law and the proposal were prepared by the majority staff of the Senate Committee on Finance.

Trade Adjustment Assistance program by two years. Third, the proposal amends section 256(b) of the Trade Act of 1974 to extend the authorization for the TAA for Firms program until December 31, 2010. Fourth, the proposal amends section 298(a) of the Trade Act of 1974 to extend the TAA for Farmers program until December 31, 2010. Fifth, the proposal amends section 285 of the Trade Act of 1974 to extend the overall termination date of the TAA programs until December 31, 2010. Sixth, the proposal provides that these amendments shall have an effective date of January 1, 2008. Seventh, the proposal includes a Sense of the Senate that a TAA for Communities program should be revived.

### **3. Economic recovery payments to recipients of Social Security, supplement security income, railroad retirement, and Veterans disability benefits<sup>131</sup>**

#### **Present Law**

No provision.

#### **Description of Proposal**

The provision directs the Secretary of the Treasury to provide a onetime economic recovery payment of \$300 to adults who were eligible for Social Security benefits, Railroad Retirement benefits, or veterans compensation or pension benefits,<sup>132</sup> or individuals<sup>133</sup> who were eligible for Supplement Security Income (SSI) benefits (excluding individuals who receive SSI while in a Medicaid institution). Only individuals who were eligible for one of the four programs for any of the three months prior to the month of enactment shall receive an economic recovery payment.

The provision stipulates that economic recovery payments will only be made to individuals whose address of record is in 1 of the 50 states, the District of Columbia, Puerto Rico, Guam, the United States Virgin Islands, American Samoa, or the Northern Mariana Islands.

An individual shall only receive one \$300 economic recovery payment under this section regardless of whether the individual is eligible for a benefit from more than one of the four federal programs. If the individual is also eligible for the “Making Work Pay” credit from Section XX, that credit shall be reduced by the economic recovery payment made under this section.

An individual who is otherwise eligible for a economic recovery payment will not receive a payment if their federal program benefits have been suspended because they are in prison, a

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<sup>131</sup> Description of present law and the proposal were prepared by the majority staff of the Senate Committee on Finance.

<sup>132</sup> Due to administrative constraints, this category includes a small number of individuals under age 18 who are eligible for veteran compensation or pension benefits.

<sup>133</sup> This includes SSI recipients who are under age 18.

fugitive, a probation or parole violator, they committed fraud, or they are no longer lawfully present in the United States.

The provision directs the Commissioner of Social Security, the Railroad Retirement Board, and the Secretary of Veterans Affairs to provide the Secretary of the Treasury with information and data necessary in order to identify individuals eligible for economic recovery payments and to make the payments.

The provision provides that the \$300 economic recovery payments shall not be taken into account as income or taken into account as resources for the month of receipt and the following 9 months, for purposes of determining the eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

The provision provides that economic recovery payments shall not be considered gross income for income tax purposes and that the payments are protected by the assignment and garnishment provisions of the four federal benefit programs.

The provision stipulates that if an individual who is eligible for an economic recovery payment has a representative payee, the payment shall be made to the representative payee and the entire payment shall only be used for the benefit of the individual who is entitled to the economic recovery payment.

The provision appropriates the following amounts for FY2009 to carry out the provisions of this section: to the Secretary of the Treasury, funds to make the payments and \$7 million for administrative cost; to the Commissioner of Social Security, \$90 million; to the Railroad Retirement Board, \$1 million; and to the Secretary of Veterans Affairs, \$7.2 million.

#### **Effective Date**

The Secretary of the Treasury shall commence making payments as soon as possible, but no later than 120 days after the date of enactment. No economic recovery payments shall be made after December 31, 2010.

#### **4. Increase in the statutory limit on the public debt<sup>134</sup>**

##### **Present Law**

The statutory limit on the public debt is \$11,315 billion.

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<sup>134</sup> Description of present law and the proposal were prepared by the majority staff of the Senate Committee on Finance.

**Description of Proposal**

The provision increases the statutory limit on the public debt by \$825 billion to \$12,140 billion.

**Effective Date**

The provision is effective on the date of enactment.