Order Code RS22488
August 3, 2006

CRS Report for Congress
Received through the CRS Web

Lesser-Known Tax Provisions in H.R. 5970 (Estate Tax and Extension of Tax Relief Act of 2006)

Erika Lunder
Legislative Attorney
American Law Division

Summary

H.R. 5970, passed by the House on July 28, 2006, is gaining headlines as the "trifecta bill" containing three important legal changes: estate tax reduction, a minimum wage increase, and the extension of expiring tax provisions. The bill also contains a number of tax amendments that are receiving little public attention and a title amending the Surface Mining Control and Reclamation Act. This report summarizes the tax provisions in the bill, emphasizing the less-publicized tax provisions in Title II, Subtitle B. It does not cover Title III, amending the Surface Mining Control and Reclamation Act, or Title IV, amending the Fair Labor Standards Act. For more detail on the estate and gift tax, see CRS Report RL32818, *Estate Tax Legislation in the 109th Congress*, by Nonna A. Noto, and CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*, by Jane G. Gravelle and Steven Maguire. For more detail on the extender provisions, see CRS Report RL32367, *Temporary Tax Provisions ("Extenders") Expired in 2005*, by Pamela J. Jackson. For more detail on the Fair Labor Standards Act, see CRS Report RL33401, *The Fair Labor Standards Act: Minimum Wage in the 109th Congress*, by William G. Whittaker.

Title I — Estate and Gift Tax. H.R. 5970 reunifies the estate and gift tax so that the unified credit applies to taxable gifts made by an individual during his or her life and taxable transfers made by his or her estate at death. The bill gradually increases the exclusion amount from $3,750,000 in 2010 to $5,000,000 in 2015 and beyond. If the taxpayer is unable to benefit from the full exclusion, the excess may be used by the surviving spouse. Also under the bill, beginning in 2010, the taxpayer's combined taxable transfers of up to $25,000,000 are taxed at the capital gains tax rate, with the excess taxed at a flat rate that gradually declines from 40% in 2010 to 30% in 2015 and beyond. For years after 2015, both the $5,000,000 and $25,000,000 amounts are adjusted for inflation. Among other things, the bill also makes permanent the repeal of the state death tax deduction and the qualified family-owned business deduction.

Title II, Subtitle A — Extenders. Sections 201 to 223 of the bill primarily extend various expiring tax provisions.

- Extended through 2007: the deduction for qualified tuition and related expenses; the deduction for state and local sales taxes; the research and development credit (the bill makes other changes, including increasing the rates for the alternative incremental credit and creating an alternative simplified credit); the work opportunity tax credit and welfare-to-work tax credit (the bill consolidates the two credits); the election to treat combat pay as earned income for the earned income tax credit; the authority to issue qualified zone academy bonds; the deduction for expenses of school teachers; the provision allowing brownfields remediation costs to be expensed (the bill also extends the provision to the cleanup of petroleum products); the designation of the District of Columbia as an enterprise zone and the authority to issue tax-exempt bonds; the zero percent capital gains rate for qualified D.C. assets; the first-time D.C. homebuyers credit; the Indian employment tax credit; the provision allowing accelerated deprecation for business property on Indian reservations; the provision allowing 15-year straight-line cost recovery for qualified leasehold improvements; the provision suspending the limitation on the excise tax cover over on rum to Puerto Rico and the U.S. Virgin Islands; the requirement group health plans provide mental health benefits parity; the enhanced charitable contribution deduction for corporate donations of computer technology equipment; the authority for Archer medical savings accounts; the suspension of the percentage depletion method's income limitation for oil and natural gas produced from marginal properties; a limited credit for conducting economic activity in American Samoa; the authority to use certain funds for IRS undercover operations; the provisions allowing IRS disclosure of taxpayer information to facilitate combined employment tax reporting and for reasons relating to terrorist activities or income-contingent student loan repayment.

- Extended through 2008: the new markets tax credit.

- Extended through 2009: deadline for placing certain Gulf Opportunity Zone property in service in order to be eligible for bonus depreciation.

- The bill repeals New York Liberty Zone provisions providing for bonus depreciation, additional section 179 expensing, and five-year depreciation of leasehold improvements. It creates a credit against the withholding tax in IRC § 3402 for qualified New York governmental units. The credit is based on the units' expenditures for certain transportation infrastructure projects, with credits allocated to each qualifying governmental unit. No credits may be allocated after 2021, and the total amount of credits allocated between 2007 and 2021 may not exceed $1,750,000,000 (each year during this period is also subject to a limitation).

Title II, Subtitle B — Other Provisions. IRC § 199 allows a deduction for income attributable to domestic production activities. Examples of these activities are

selling property manufactured or produced in the United States, performing construction activities in the United States, and selling electricity, natural gas, or potable water produced by the taxpayer in the United States. The deduction is limited to 50% of the wages paid by the taxpayer allocable to such activities. Section 231 of the bill treats Puerto Rico as part of the United States so long as the taxpayer's gross receipts from sources within Puerto Rico are subject to U.S. taxation. The provision is effective for the first two taxable years beginning after December 31, 2005, and before January 1, 2008.

One step in calculating a taxpayer's liability under the alternative minimum tax is adding back various tax preference items to his or her taxable income, as computed under the regular income tax. Some of the adjustments result in the taxpayer losing the benefit of tax deferral. In order to avoid double taxation (i.e., taxing the item in the current year under the AMT and again in a future year under the regular income tax), these deferral adjustments yield a minimum tax credit that the taxpayer may carry forward to reduce regular income taxes in future years. Section 232 of the bill makes the minimum tax credit partially refundable for unused credits that have been carried forward for a number of years. The unused credit must be from taxable years beginning before January 1, 2013. The refundable credit is phased out for higher-income individuals.

Under IRC § 6039, corporations involved in a transfer of stock options to an individual must provide information about the transfer to the individual. Section 233 requires that the corporation file a return with the IRS in addition to providing information to the person involved in the transfer.

Section 234 of the bill allows taxpayers to expense 50% of the cost of qualified mine safety equipment property for use in a U.S. underground mine. The original use of the property must commence with the taxpayer, and the property must be placed in service before 2009. Section 235 creates a tax credit for employers based on the training program costs of qualified mine rescue team employees. The credit equals 20% of the costs, limited to $10,000, paid for each qualified employee (including wages while attending the training program). The provision expires on December 31, 2008.

IRC § 7623 allows the IRS to pay sums to whistleblowers who provide information that assists the IRS in detecting tax underpayment and other violations of the tax laws. The award is based on the amount collected, other than interest. The IRS has set the maximum award at 15% of the amount collected, which is reduced further depending on the specificity of the information and its value in determining the tax liability. The maximum award may not exceed $10 million. Section 236 makes several changes to the whistleblower provision. Under the bill, if the provided information leads the IRS to proceed with an administrative or judicial action, the award is between 15% and 30% of the amount collected. The award is reduced if information from sources other than the whistleblower was more useful to the IRS in proceeding with the action. These provisions apply only if the action involves a disputed amount in excess of $2 million and, if the taxpayer in the action is an individual, his or her gross income exceeds $200,000. The section also requires the IRS to take initial steps with respect to creating a Whistleblower Office to administer the award program. Further, section 236 creates an above-the-line deduction for attorney's fees and costs paid by an individual in connection with providing the information and allows the individual to appeal the amount or denial of an award to the U.S. Tax Court.

IRC § 6702 imposes a penalty of up to $500 on individuals who file a frivolous income tax return. Section 237 of the bill increases the maximum penalty to $5,000 and applies the penalty provision to all taxpayers and all federal taxes. In addition, the section allows the IRS to impose a penalty of up to $5,000 on taxpayers who make frivolous submissions for collection due process hearings, installment agreements, offers-in-compromise and taxpayer assistance orders, unless the taxpayer withdraws the submission. The section further authorizes the IRS to disregard such submissions. Section 237 also requires that the IRS publish a list of frivolous positions, arguments, requests, and submissions.

IRC § 4131 imposes an excise tax equal to 75 cents per dose on certain vaccines. Section 238 adds the meningococcal and human papillomavirus vaccines to the list of taxable vaccines.

Settlement funds are sometimes established by agreement between the Environmental Protection Agency and a private party to pay for the cleanup of hazardous waste sites. Under IRC § 468B, as amended by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA, P.L. 109-222), qualifying settlement funds are exempt from income tax. Section 239 of the bill makes this treatment permanent.

During a corporate division such as a spin-off, a distribution of stock in a controlled subsidiary by a parent corporation to its shareholders is tax free to both the distributing corporation and the shareholders if the requirements in IRC § 355 are met. One requirement is that both the parent corporation and subsidiary must have engaged in the active conduct of a trade or business for at least five years. Under TIPRA, the “active conduct” test is determined looking at the activities of the entire affiliated group, and not just the parent and subsidiary. Section 240 of H.R. 5970 makes the TIPRA provision permanent.

Under IRC § 143, the proceeds of qualified veterans’ mortgage bonds must be used to make mortgage loans to qualified veterans. Only certain states may issue these bonds, and they are limited in the amount that may be issued. TIPRA gradually increased the limits for Alaska, Oregon, and Wisconsin so that the limit in 2010 for each state is $25 million, but the amount is reduced to zero for years after 2010. Section 241 of the bill makes the $25 million limit permanent for these three states.

Prior to TIPRA, the sale of self-created musical works resulted in ordinary income. TIPRA created a temporary rule that allows the taxpayer to treat the work as a capital asset and, therefore, to be taxed on the gain from the sale at the applicable capital gains rates. Section 242 of the bill makes the TIPRA provision permanent.

IRC §§ 1352 to 1359 provide special rules that allow corporations operating qualified vessels involved in international shipping activities to pay a tax based on tonnage as opposed to the corporate income tax. The vessel must be a U.S. flag vessel of at least 10,000 deadweight tons and be used exclusively in foreign trade. Incidental use in domestic trade is permitted if the operator provides notice to the IRS; however, if the vessel is used for domestic trade for more than 30 days during the year, the vessel is no longer treated as a qualified vessel. TIPRA lowered the 10,000 ton limitation to 6,000. Section 243 of H.R. 5970 makes that provision permanent. Section 245 eases the rules

regarding notice and the 30 day limit for qualifying vessels operating in the Great Lakes Waterway and St. Lawrence Seaway.

The arbitrage provision in IRC § 148 disallows the exemption of interest on state or local government bonds if the proceeds are invested in higher-yield investments or if the debt service on the bonds is secured by or paid from those investments. An exception has existed since 1984 that allows the income from the investments of the Texas Permanent University Fund to secure a limited amount of bonds issued by the state university systems. Changes made to the Texas constitution in 1999 have resulted in the 1984 exception not accurately reflecting the relationship between the Fund and the systems, but the IRS has agreed to continue to apply the 1984 exception through August 2007. TIPRA extended the treatment through August 2009. Section 244 of H.R. 5970 makes the treatment permanent.

Under IRC § 143, mortgage revenue bonds are tax-exempt bonds used to finance below-market rate mortgages for low- and moderate-income homebuyers who have not owned a home for the past three years. Section 246 waives the three-year requirement for bonds used to finance residences for veterans. A veteran may only use the waiver once. The provision applies to bonds issued between the bill's date of enactment and January 1, 2008.

Under IRC § 121, taxpayers may exclude from gross income up to $250,000 ($500,000 if married filing jointly) of the gain realized from the sale of a principal residence. One eligibility requirement is that the taxpayer must have used the property as a principal residence for at least two of the five years preceding the date of sale. A taxpayer may elect to suspend the 5-year period for up to 10 years during the time that the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or U.S. Foreign Service. Section 247 makes employees of the intelligence community eligible to make the suspension election. The section applies to sales made between the bill's date of enactment and January 1, 2011.

IRC § 45K allows a credit for producing fuel from a non-conventional source. The credit is phased out as the reference price of oil exceeds $23.50 per barrel (adjusted for inflation). Special rules apply to facilities producing coke and coke gas. Section 248 clarifies that these facilities do not include those that produce coke or coke gas from petroleum-based products and exempts them from the credit phase out.

IRC § 1043 allows officers and employees of the executive branch who must sell property to comply with conflict-of-interest requirements to defer tax by reinvesting the gain from the sale in certain investments. Section 249 extends the treatment to judicial officers.

IRC § 163 allows a deduction for interest paid on acquisition indebtedness or home equity indebtedness for the taxpayer's residence. Section 250 treats qualified mortgage insurance premiums as such interest for taxpayers with adjusted gross income below $110,000. The treatment does not apply to mortgage insurance contracts issued before January 1, 2007, or amounts paid after December 31, 2007.

IRC § 6427 allows a partial refund for the fuel excise taxes paid on kerosene if the fuel is used for a non-taxable use. Generally, the ultimate purchaser may claim the refund

or may waive the refund so it may be claimed by the ultimate vendor. In the case of noncommercial aviation, only the ultimate vendor may claim the refund. Section 251 changes the noncommercial aviation rule to allow the purchaser to claim the refund or waive it so the ultimate vendor may claim it. The section also allows the ultimate purchaser of kerosene used in aviation for a non-taxable farming purpose to claim a refund for taxes paid on purchases made between December 31, 2004, and October 1, 2005, reduced by any refunds claimed by the ultimate vendor.

Under IRC § 631, a taxpayer may treat the gain from certain sales or other dispositions of timber as capital gains, which are subject to lower tax rates than ordinary income. Section 252 provides an above-the-line deduction of up to 60% of the taxpayer's qualified timber gain for the year, but the taxpayer must then treat the remaining 40% as ordinary income. The provision applies to dispositions of timber prior to January 1, 2008.

Section 253 creates a new credit for holders of rural renaissance bonds. Among other things, the bonds must be part of an issue of which at least 95% of the proceeds are used for capital expenditures incurred for qualified projects. The bonds must also be issued prior to January 1, 2010. Qualified projects include projects in rural areas for water or waste treatment, affordable housing, community facilities, certain agriculture purposes, distance learning or telemedicine, rural utility infrastructure, expanding broadband technology, and teleworks. The credit would equal 25% of a deemed interest subsidy determined by the Treasury Secretary. No more than $200,000,000 of bonds may be issued.

IRC § 274(m)(3) disallows a deduction for travel expenses of an individual, such as a spouse or dependent, accompanying a taxpayer on business travel unless the individual is the taxpayer's employee, the individual's travel is for a bona fide business purpose, and the expenses are otherwise deductible by the individual. Section 254 repeals the provision through 2007.

Section 255 contains technical corrections clarifying IRS regulatory authority under section 103(b) of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222), relating to subpart F income, and authority to permit interest suspension under section 903 of the American Jobs Creation Act of 2004 (P.L. 108-357).