TECHNICAL EXPLANATION OF THE "SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007" AND PENSION RELATED PROVISIONS CONTAINED IN H.R. 2206 AS CONSIDERED BY THE HOUSE OF REPRESENTATIVES ON MAY 24, 2007

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JOINT COMMITTEE ON TAXATION

May 24, 2007
JCX-29-07

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the "Small Business and Work Opportunity Tax Act of 2007" and pension related provisions contained in H.R. 2206 as considered by the House of Representatives on May 24, 2007.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the "Small Business and Work Opportunity Tax Act of 2007" And Pension Related Provisions Contained in H.R. 2206 as Considered by the House of Representatives on May 24, 2007*, (JCX-29-07), May 24, 2007. This publication is also available on the web at www.house.gov/jct.

I. SMALL BUSINESS TAX RELIEF PROVISIONS

A. General Provisions

1. Extension and modification of work opportunity tax credit (sec. 8211 of the bill and sec. 51 of the Code)

<u>**Present Law**</u>

<u>**In general**</u>

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).

<u>**Targeted groups eligible for the credit**</u>

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

<u>(1) Families receiving TANF</u>

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.

<u>(2) Qualified veteran</u>

A qualified veteran is a veteran who is certified by the designated local agency as a member of a family certified as 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.

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.

<u>(3) Qualified ex-felon</u>

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 date of conviction.

<u>(4) High-risk youth</u>

A high-risk youth is an individual certified as being at least age 18 but not yet age 25 on the hiring date and 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 (the ("Code")). Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, or renewal community.

<u>(5) Vocational rehabilitation referral</u>

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; or (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. 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.

<u>(6) Qualified summer youth employee</u>

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15, (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who has not been an employee of that employer before, and (4) 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 high-risk youths, 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.

<u>(7) Qualified food stamp recipient</u>

A qualified food stamp recipient is an individual aged 18 but not yet 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: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) 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)[2] if the individual is hired within two years after the date that the 18-month total is reached; or (3) 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 sec. 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

[2] 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.

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 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).

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 December 31, 2007.

Explanation of Provision

Extension

The provision extends the work opportunity tax credit for 44 months (for qualified individuals who begin work for an employer after December 31, 2007, and before September 1, 2011).

Qualified veterans targeted group

The provision expands the qualified veterans' targeted group to include 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. Being entitled to compensation for a service-connected disability is defined with reference to section 101 of Title 38, U.S.C., which means having a disability rating of 10-percent or higher for service connected injuries.

Qualified first-year wages

The provision expands the definition of qualified first-year wages from $6,000 to $12,000 in the case of individuals who qualify under either of the new expansions of the qualified veteran group, above. The 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.

High-risk youth targeted group

The provision expands the definition of high-risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. Also, the provision expands the definition of eligible individuals under this category to include otherwise qualifying individuals from rural renewal counties. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined the Office of Management and Budget) which had a net population loss during the five-year periods 1990-1994 and 1995-1999. Finally, the provision changes the name of the category to the "designated community residents" targeted group.

Vocational rehabilitation referral targeted group

The provision expands the definition of vocational rehabilitation referral to include any 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, an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act.

Certification

Under present law, designated local employment agencies may enter into information sharing agreements to facilitate certification for purposes of WOTC eligibility. Such agreements are subject to confidentiality requirements. The Congress expects that the Department of Defense, the Department of Veterans Affairs, and the Social Security Administration will work with the designated local agencies to facilitate certification of the expansions of the qualified veteran category and the SSI recipient category. Finally, the Congress expects that the Internal Revenue Service will develop procedures to allow (in addition to original documents) paper versions of electronically completed pre-screening notices and photographic copies of hand signed original pre-screening notices for purposes of the credit. This allowance of pre-screening notices which are not original documents should be allowed only to the extent it does not foster incorrect or fraudulent filings.

Effective Date

The provisions are effective for individuals who begin work for an employer after the date of enactment.

2. Increase and extension of expensing for small business (sec. 8212 of the bill and sec. 179 of the Code)

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 2003 through 2009, is \$100,000 of the cost of qualifying property placed in service for the taxable year.[3] 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 2010 is treated as qualifying property. The \$100,000 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 \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2010. For taxable years beginning in 2007, the inflation-adjusted amounts are \$112,000 and \$450,000, respectively.[4]

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 provision). 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

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[3] 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), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[4] Rev. Proc. 2006-53, sec. 2.19, 2006-48 I.R.B. 996 (Nov. 27, 2006).

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.[5]

For taxable years beginning in 2010 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. 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.[6]

Explanation of Provision

The provision increases the $100,000 and $400,000 amounts to $125,000 and $500,000, respectively, for taxable years beginning in 2007 through 2010. These amounts are indexed for inflation in taxable years beginning after 2007 and before 2011.

In addition, the provision extends for one year the increased amount that a taxpayer may deduct and the other section 179 rules applicable in taxable years beginning before 2010. Thus, under the provision, these rules continue in effect for taxable years beginning after 2009 and before 2011.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

3. Determination of credit for certain taxes paid with respect to employee cash tips (sec. 8213 of the bill and sec. 45B of the Code)

Present Law[7]

The Federal minimum wage under the Fair Labor Standards Act (the "FLSA") is $5.15 per hour. In the case of tipped employees, the FLSA provides that the minimum wage may be

[5] 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 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.

[6] Sec. 179(c)(2).

[7] A separate provision of H.R. 2206 increases the Federal minimum wage.

reduced to $2.13 per hour (that is, the employer is only required to pay cash equal to $2.13 per hour) if the combination of tips and cash income equals the Federal minimum wage.[8]

Under present law, employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA"). Employees are required to report the amount of tips received.

A business tax credit is provided equal to an employer's FICA taxes paid on tips in excess of those treated as wages for purposes of meeting the minimum wage requirements of the FLSA. The credit applies only with respect to FICA taxes paid on tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary. The credit is available whether or not the employee reports the tips on which the employer FICA taxes were paid. No deduction is allowed for any amount taken into account in determining the tip credit. A taxpayer may elect not to have the credit apply for a taxable year.

Explanation of Provision

The provision provides that the amount of the tip credit is based on the amount of tips in excess of those treated as wages for purposes of the FLSA as in effect on January 1, 2007. That is, under the provision, the tip credit is determined based on a minimum wage of $5.15 per hour. Therefore, if the amount of the minimum wage increases, the amount of the FICA tip credit will not be reduced.

Effective Date

The provision applies with respect to tips received for services performed after December 31, 2006.

4. Waiver of individual and corporate alternative minimum tax limits on work opportunity credit and credit for taxes paid with respect to employee cash tips (sec. 8214 of the bill and sec. 38 of the Code)

Present Law

Under present law, business tax credits generally may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000). Credits in excess of the limitation may be carried back one year and carried over for up to 20 years.

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[8] Some States require the payment of cash wages to tipped employees in excess of the Federal minimum of $2.13 per hour. For a history of the tip provisions under the FLSA and a description of relevant State laws, see William G. Whittaker, Congressional Research Service, *The Tip Credit Provisions of the Fair Labor Standards Act* (Order Code RL33348), March 24, 2006.

The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

Thus, business tax credits generally cannot offset the alternative minimum tax liability.

Explanation of Provision

The provision treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the work opportunity credit and the credit for taxes paid with respect to employee cash tips.

Thus, the work opportunity tax credit and the credit for taxes paid with respect to cash tips may offset the alternative minimum tax liability.

Effective Date

The provision applies to credits determined in taxable years beginning after December 31, 2006.

5. Family business tax simplification (sec. 8215 of the bill and sec. 761 of the Code)

Present Law

Under present law, a partnership is defined to include a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a trust or estate or a corporation (sec. 7701(a)(2)). A partnership is treated as a pass-through entity, and income earned by the partnership, whether distributed or not, is taxed to the partners. The income of a partnership and its partners is determined under subchapter K of the Code. An election not to be subject to the rules of subchapter K is provided for certain partnerships that meet specified criteria (e.g., the partnership is for investment purposes only, is for the joint production, extraction or use of property but not for selling services or property produced or extracted, or is used by securities dealers for short periods to underwrite, sell or distribute securities). Otherwise, the rules of subchapter K apply to a venture that is treated as a partnership for Federal tax purposes.

In the case of an individual with self-employment income, the income subject to self-employment tax is the net earnings from self-employment (sec. 1402(a)). Net earnings from self-employment is the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules. If the individual is a partner in a partnership, the net earnings from self-employment generally include his or her distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership.

Explanation of Provision

The provision generally permits a qualified joint venture whose only members are a husband and wife filing a joint return not to be treated as a partnership for Federal tax purposes. A qualified joint venture is a joint venture involving the conduct of a trade or business, if (1) the only members of the joint venture are a husband and wife, (2) both spouses materially participate in the trade or business, and (3) both spouses elect to have the provision apply.

Under the provision, a qualified joint venture conducted by a husband and wife who file a joint return is not treated as a partnership for Federal tax purposes. All items of income, gain, loss, deduction and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Thus, it is anticipated that each spouse would account for his or her respective share on the appropriate form, such as Schedule C. The provision is not intended to change the determination under present law of whether an entity is a partnership for Federal tax purposes (without regard to the election provided by the provision).

For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for Federal income tax purposes under the provision (i.e., in accordance with their respective interests in the venture). A corresponding change is made to the definition of net earnings from self-employment under the Social Security Act. The provision is not intended to prevent allocations or reallocations, to the extent permitted under present law, by courts or by the Social Security Administration of net earnings from self-employment for purposes of determining Social Security benefits of an individual.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

B. Gulf Opportunity Zone Tax Incentives

1. Extension of increased expensing for qualified section 179 Gulf Opportunity Zone property (sec. 8221 of the bill and sec. 1400N(e) of the Code)

Present Law

In general

Present law provides that, 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. The maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2009, is $100,000 of the cost of qualifying property placed in service for the taxable year.[9] 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 2010 is treated as qualifying property. The $100,000 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 $400,000. The $100,000 and $400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2010. For taxable years beginning in 2007, the inflation-adjusted amounts are $112,000 and $450,000, respectively.[10]

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 provision). 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.[11]

For taxable years beginning in 2010 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

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[9] 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).

[10] Rev. Proc. 2006-53, sec. 2.19, 2006-48 I.R.B. 996 (Nov. 27, 2006).

[11] 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 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.

placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. 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.[12]

Increase for Gulf Opportunity Zone Property

Under section 1400N(e), the $100,000 maximum amount that a taxpayer may elect to deduct under section 179 is increased by the lesser of $100,000 or the cost of qualified section 179 Gulf Opportunity Zone property for the taxable year. The provision applies with respect to qualified section 179 Gulf Opportunity Zone property acquired on or after August 28, 2005, and placed in service on or before December 31, 2007. Thus, in addition to the $100,000 maximum cost of any section 179 property (including property that also meets the definition of qualified section 179 Gulf Opportunity Zone property) that may be deducted under present law, a taxpayer may elect to deduct a maximum $100,000 additional amount of the taxpayer's cost of qualified section 179 Gulf Opportunity Zone property, resulting in a maximum deductible amount of $200,000 of qualified section 179 Gulf Opportunity Zone property. (The $100,000 present-law portion of this amount is indexed for taxable years beginning after 2003 and before 2010, so the total may be higher than $200,000 after taking indexation of this portion into account.) The $100,000 additional amount for the cost of qualified section 179 Gulf Opportunity Zone property is not indexed.

There is a special rule for the reduction in the $200,000 maximum deduction for the cost of qualified section 179 Gulf Opportunity Zone property. Under this rule, the $200,000 amount is reduced (but not below zero) by the amount by which the cost of qualified section 179 Gulf Opportunity Zone property placed in service during the taxable year exceeds a dollar cap of up to $1 million. (The $400,000 present-law portion of this amount is indexed for taxable years beginning after 2003 and before 2010, so the total may be higher than $1 million after taking indexation of this portion into account.) The dollar cap is computed by increasing the $400,000 present-law amount by the lesser of (1) $600,000, or (2) the cost of qualified section 179 Gulf Opportunity Zone property placed in service during the taxable year. The $600,000 amount is not indexed.

Qualified section 179 Gulf Opportunity Zone property means section 179 property (as defined in section 179(d)) that also meets the requirements to qualify for Gulf Opportunity Zone bonus depreciation. Specifically, for section 179 purposes, qualified Gulf Opportunity Zone property is property (1) described in section 168(k)(2)(A)(i), (2) substantially all of the use of which is in the Gulf Opportunity Zone and is in the active conduct of a trade or business by the taxpayer in that Zone, (3) the original use of which commences with the taxpayer on or after August 28, 2005, (4) which is acquired by the taxpayer by purchase on or after August 28, 2005, but only if no written binding contract for the acquisition was in effect before August 28, 2005, and (5) which is placed in service by the taxpayer on or before December 31, 2007. Such

[12] Sec. 179(c)(2).

property does not include alternative depreciation property, tax-exempt bond-financed property, or qualified revitalization buildings.

These rules are coordinated with expensing rules with respect to enterprise zone businesses in empowerment zones and with respect to renewal communities. For purposes of those rules, qualified section 179 Gulf Opportunity Zone property is not treated as qualified zone property or qualified renewal property, unless the taxpayer elects not to take such property into account for purposes of the increased section 179 expensing. Thus, a taxpayer acquiring property that could qualify as either qualified section 179 Gulf Opportunity Zone property, or qualified zone property or qualified renewal property, may elect the additional expensing provided either under this provision, or under the empowerment zone or renewal community rules, but not both, with respect to the property.

Recapture rules apply to this property if recapture applies under section 179(d)(10) or if the property ceases to be qualified section 179 Gulf Opportunity Zone property.

Explanation of Provision

The provision extends the increased expensing amount for property substantially all of the use of which is in one or more specified portions of the GO Zone to property placed in service by the taxpayer on or before December 31, 2008. The specified portions of the Go Zone include the Louisiana parishes of Calcasieu, Cameron, Orleans, Plaquemines, St. Bernard, St. Tammany, and Washington, and the Mississippi counties of Hancock, Harrison, Jackson, Pearl River, and Stone.[13]

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

2. Extension and expansion of low-income housing credit rules for buildings in the GO Zones (sec. 8222 of the bill and 1400N(c) of the Code)

Present Law

In general

The low-income housing credit may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

[13] The "specified portions of the Go Zone" as defined by section 1400N(d)(6) are identified by the Secretary in Notice 2007-36, 2007-17 I.R.B 1000.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments of the credit have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Credit cap

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Credit cap is provided to the States annually. For 2006, the amount is $1.90 per resident with a minimum annual cap of $2,180,000 for certain small population States. These amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

Under the Gulf Opportunity Zone Act of 2005, the otherwise applicable housing credit ceiling amount is increased for each of the States within the Gulf Opportunity Zone (Alabama, Louisiana, and Mississippi). The additional credit cap for each of the affected States equals $18.00 times the number of such State's residents within the Gulf Opportunity Zone. This increase applies to calendar years 2006, 2007, and 2008. This amount is not adjusted for inflation. For purposes of the additional credit cap amount, the determination of population for any calendar year is made on the basis of the most recent census estimate of the resident population of the State in the Gulf Opportunity Zone released by the Bureau of the Census before August 28, 2005. In addition, under the Gulf Opportunity Zone Act of 2005, the otherwise applicable housing credit ceiling amount is increased for Florida and Texas by $3,500,000 per State. This increase applies only to calendar year 2006.

Carryover allocation rule

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. In general, the allocation must be made not later than the close of the calendar year in which the building is placed in service. One exception to this rule is a carryover allocation. In the case of a carryover allocation, an allocation may be made to a building that has not yet been placed in service, provided that: (1) more than ten percent of the taxpayer's reasonably expected basis in the project (as of the close of the second calendar year following the calendar year of the allocation) is incurred as of the later of six months after the allocation is made or the end of the calendar year in which the allocation is made; and (2) the building is placed in service not later than the close of the second calendar year following the calendar year of the allocation.

Enhanced credit

Generally, buildings located in high cost areas (i.e., qualified census tracts and difficult development areas) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credit is increased to a 91-percent and 39-percent credit, respectively.

The mechanism for this increase is an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit is that no area having more than 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area can be a difficult to develop area and therefore a high cost area eligible for this treatment.

Under the Gulf Opportunity Zone Act of 2005, the Gulf Opportunity Zone, the Rita GO Zone, and the Wilma GO Zone (the, "Go Zones") are treated as high-cost areas for purposes of the low income housing credit for property placed-in-service in calendar years 2006, 2007, and 2008. Therefore, buildings located in the GO Zones are eligible for the enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to 91-percent and 39-percent credits, respectively. The 20-percent of population restriction is waived for this purpose. This enhanced credit applies regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap provided under the Gulf Opportunity Zone Act of 2005 The provision to treat the GO Zones as a high-cost area is generally effective for calendar years beginning after 2005 and before 2009, and for buildings placed-in-service during such period in the case of projects that also receive financing with the proceeds of tax-exempt bonds subject to the private activity bond volume limit which are issued after December 31, 2005.

Definition of Federally subsidized

In general, any newly constructed or substantially rehabilitated building is treated as Federally subsidized for any taxable year if, at any time during such taxable year or prior taxable year, there is or was outstanding any obligation the interest on which is exempt under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof. Exceptions are provided from this general rule: (1) if the taxpayer elects to reduce eligible basis; and (2) for certain subsidized construction financing. For purposes of this rule, a below market Federal loan generally is defined as a loan funded, in whole or in part, with Federal funds if the interest payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) (as of the date the loan was made). A loan is not treated as a below market Federal loan for these purposes, if it is below market solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974, as in effect on December 19, 1989 (the date of enactment of the Omnibus Budget Reconciliation Act of 1989).

Rehabilitation expenditures

Rehabilitation expenditures paid or incurred by the taxpayer with respect to any building shall be treated as a separate new building for purposes of the credit. In general, rehabilitation expenditures are amounts chargeable to a capital account and incurred for property (or additions or improvements to property) of a character subject to depreciation in connection with the rehabilitation of a building. Such term does not include the cost of acquiring a building (or interest therein). Other rules, including a minimum expenditure requirement, apply.

Explanation of Provision

Carryover allocation rule

The provision makes two modifications to the carryover allocation rule for otherwise qualifying buildings located in the GO Zones placed in service before January 1, 2011. First, it repeals the requirement that 10 percent of the taxpayer's reasonably expected basis in the project (as of the close of the second calendar year following the calendar year of the allocation) must be incurred as of the later of six months after the allocation is made or the end of the calendar year in which the allocation is made (the “10-percent rule”). Second, it repeals the requirement that such building be placed in service not later than the close of the second calendar year following the calendar year of the allocation (the “second-year placed in service rule”). These changes apply only to allocations made in 2006, 2007, or 2008 whether made out of the regular credit cap or the additional Gulf Opportunity Zone credit cap. Therefore, an otherwise qualifying building is treated as a qualifying for the credit regardless of whether the 10-percent rule or the second-year placed in service rule are satisfied if such building in one of the GO Zones: (1) receives an allocation in 2006, 2007, or 2008; and (2) is placed in service before January 1, 2011.

Enhanced credit

The provision extends the placed in service dates for buildings eligible for the enhanced credit available under the Gulf Opportunity Zone Act of 2005 for two additional years (2009 and 2010) for allocations made in 2006, 2007, or 2008. The provision to treat the GO Zones as a high-cost area is generally effective for calendar years beginning after December 31, 2008 and before January 1, 2011, and for buildings placed-in-service during such period in the case of projects that also receive financing with the proceeds of tax-exempt bonds subject to the private activity bond volume limit which are issued during that period. Therefore, otherwise qualifying buildings located in the GO Zones generally are eligible for the enhanced credit for allocations made in 2006, 2007, or 2008, if placed in service after December 31, 2005 and before January 1, 2011.

Definition of Federally subsidized

The provision modifies the definition of below market Federal loan for otherwise qualifying buildings located in the GO Zones that are placed in service during the period beginning on January 1, 2006 and ending on December 31, 2010. Under the provision, a loan is not treated as a below market Federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 by reason of: (1) section 122 of that Act; (2) any provision of the Department of Defense Appropriations Act, 2006 (Pub. L. No. 109-141); or (3) the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery, 2006 (Pub. L. No. 109-234). Therefore, such assistance will not cause an otherwise qualifying building receiving such assistance to be treated as Federally subsidized for purposes of the low income housing credit.

Rehabilitation expenditures

The Congress expects that the present law rules treating rehabilitation expenses as a separate new building for purposes of the low-income housing credit will apply in the case of buildings in the GO Zones which have been destroyed and, therefore, must be rehabilitated. For example, if a building receiving the low-income housing credit (with an eligible basis of $100 for credit purposes) was destroyed and the cost of replacing the building is $150, then the Congress expects that present law rules may allow the expenditures that exceed $100 but do not exceed $150 to be treated as a separate building with separate credit and compliance periods, assuming the rehabilitation expenditure receives a credit allocation and meets the otherwise applicable low income housing tax credit requirements.

Effective Date

The provisions are effective upon enactment.

3. Special tax-exempt bond financing rule for repairs and reconstructions of residences in the GO Zones (sec. 8223 of the bill and secs. 143 and 1400N(a) of the Code)

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 which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds with respect to 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"). The definition of a qualified private activity bond includes a qualified mortgage bond.

Qualified mortgage bonds

Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a "first-time homebuyer" requirement. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or replace existing mortgages.

Exceptions to the new mortgage requirement are provided for the replacement of construction period loans, bridge loans, and other similar temporary initial financing. In addition, qualified rehabilitation loans may be used, in part, to replace existing mortgages. A qualified rehabilitation loan means certain loans for the rehabilitation of a building if there is a period of at least 20 years between the date on which the building was first used (the "20 year rule") and the date on which the physical work on such rehabilitation begins and the existing walls and basis requirements are met. The existing walls requirement for a rehabilitated building is met if 50 percent or more of the existing external walls are retained in place as external walls, 75 percent or more of the existing external walls are retained in place as internal or external walls, and 75 percent or more of the existing internal structural framework is retained in place. The basis requirement is met if expenditures for rehabilitation are 25 percent or more of the mortgagor's adjusted basis in the residence, determined as of the later of the completion of the rehabilitation or the date on which the mortgagor acquires the residence.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Qualified home-improvement loans may not exceed $15,000, and may not be used to refinance existing mortgages.

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the "State volume cap"). For calendar year 2007, the State volume cap, which is indexed for inflation, equals the greater of $85 per resident of the State, or $256.24 million. Exceptions from the State volume cap are provided for bonds issued for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

Gulf Opportunity Zone Bonds

The Gulf Opportunity Zone Act of 2005 (the "Act") authorizes Alabama, Louisiana, and Mississippi (or any political subdivision of those States) to issue qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone ("Gulf Opportunity Zone Bonds"). Gulf Opportunity Zone Bonds are not subject to the State volume cap. Rather, the maximum aggregate amount of Gulf Opportunity Zone Bonds that may be issued in any eligible State is limited to $2,500 multiplied by the population of the respective State within the Gulf Opportunity Zone.

Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone are treated as qualified mortgage bonds if the general requirements for qualified mortgage bonds are met. The Code also provides special rules for Gulf Opportunity Zone Bonds issued to finance residences located in the Gulf Opportunity Zone. For example, the first-time homebuyer rule is waived and the income and purchase price rules are relaxed for residences financed in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. In addition, the Code increases from $15,000 to $150,000 the amount of a qualified home-improvement loan with respect to residences located in the specified disaster areas. Gulf Opportunity Zone Bonds must be issued before January 1, 2011.

Explanation of Provision

Under the provision, a qualified GO Zone repair or reconstruction loan is treated as a qualified rehabilitation loan for purposes of the qualified mortgage bond rules. Thus, such loans financed with the proceeds of qualified mortgage bonds and Gulf Opportunity Zone Bonds may be used to acquire or replace existing mortgages, without regard to the existing walls or 20 year rule under present law. The provision defines a qualified GO Zone repair or reconstruction loan as any loan used to repair damage caused by Hurricane Katrina, Hurricane Rita, or Hurricane Wilma to a building located in the GO Zones (or reconstruction of such building in the case of damage constituting destruction) if the expenditures for such repair or reconstruction are 25 percent or more of the mortgagor's adjusted basis in the residence. For purposes of the provision, the mortgagor's adjusted basis is determined as of the later of (1) the completion of the repair or reconstruction or (2) the date on which the mortgagor acquires the residence.

Effective Date

The provision applies to owner-financing provided after the date of enactment and before January 1, 2011.

4. GAO study of practices employed by State and local governments in allocating and utilizing tax incentives provided pursuant to the Gulf Opportunity Zone Tax Act of 2005 (sec. 8224 of the bill)

Present Law

There is no requirement under present law that the Government Accountability Office ("GAO") study and report on the utilization of tax incentives in the GO Zones.

Explanation of Provision

The provision requires the GAO to conduct a study of the practices employed by State and local governments, and subdivisions thereof, in allocating and utilizing tax incentives provided pursuant to the Gulf Opportunity Act of 2005 (Pub. L. No.109-135) and this bill.

Not more than one year after the date of enactment of this bill, the GAO must submit a report to the House Committee on Ways and Means and the Senate Committee on Finance on the findings of its study and recommendations, if any, relating to such findings. If the GAO report includes findings of significant fraud, waste or abuse, then each of the two committees should hold public hearings to review such findings within 60 days of the submission of the report.

Effective Date

The provision is effective on the date of enactment.

C. Subchapter S Provisions
(secs. 8231-8236 of the bill and secs. 641, 1361 and 1362 of the Code)

Overview

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

1. Capital gain not treated as passive investment income

Present Law

Passive investment income

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, gain or loss from any section 1256 contract (or related property) of an options or commodities dealer, or certain interest and dividend income of banks and depository institution of holding companies.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

Explanation of Provision

The provision eliminates gains from sales or exchanges of stock or securities as an item of passive investment income.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

2. Treatment of bank director shares

Present Law

An S corporation may have no more than 100 shareholders and may have only one outstanding class of stock.

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.[14]

National banking law requires that a director of a national bank own stock in the bank and that a bank have at least five directors.[15] A number of States have similar requirements for State-chartered banks. In some cases, a bank director enters into an agreement under which the bank (or a holding company) will reacquire the stock upon the director's ceasing to hold the office of director, at the price paid by the director for the stock.[16]

Explanation of Provision

Under the provision, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S.[17] Thus, the stock is not treated as a second class of stock; a director is not treated as a shareholder of the S corporation by reason of

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[14] Sec. 1361(c)(4). Treasury regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of, or below, the fair market value of the stock. Treas. Reg. sec. 1.1361-1(l).

[15] 12 U.S.C. secs. 71-72.

[16] See Private Letter Ruling 200217048 (January 24, 2002) describing such an agreement and holding that it creates a second class of stock. Nonetheless, the ruling concluded that the election to be an S corporation was inadvertently invalid and that an amended agreement did not create a second class of stock so that the corporation's election was validated.

[17] No inference is intended as to the proper income tax treatment of restricted bank director stock or other similar stock under present law.

the stock; the stock is disregarded in allocating items of income, loss, etc. among the shareholders; and the stock is not treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary.

Restricted bank director stock is stock in a bank (as defined in sec. 581), or a depository institution holding company (within the meaning of sec. 3(w)(1) of the Federal Deposit Insurance Act), if the stock is required to be held by an individual under applicable Federal or State law in order to permit the individual to serve as a director of the bank or holding company and which is subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder is required to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

A distribution (other than a payment in exchange for the stock) with respect to the restricted stock is includible in the gross income of the director and is deductible by the S corporation for the taxable year that includes the last day of the director's taxable year in which the distribution is included in income.

Effective Date

The provision applies to taxable years beginning after December 31, 2006.

The provision also provides that restricted bank director stock is not treated as a second class of stock for taxable years beginning after December 31, 1996.

3. Treatment of banks changing from reserve method of accounting

Present Law

A financial institution which uses the reserve method of accounting for bad debts may not elect to be an S corporation.[18] If a financial institution changes from the reserve method of accounting, there is taken into account for the taxable year of the change adjustments to taxable income necessary to prevent amounts from being duplicated or omitted by reason of the change.[19]

Positive adjustments (i.e., additions to taxable income) are generally spread over four taxable years beginning in the year of change.[20] Negative adjustments (i.e., reductions to taxable income) are generally taken into account entirely in the year of change.[21]

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[18] Sec. 1361(b)(2)(A).

[19] Sec. 481.

[20] Rev. Proc. 2002-19, 2002-1 C.B. 696.

[21] Id.

In the case of a financial institution that changes from the reserve method and elects to be an S corporation for the year of change, the adjustments are both included in the income of the shareholders and are taken into account in computing the tax on built-in gain under section 1374. If the change in accounting method is made for the last taxable year prior to becoming an S corporation, any adjustments for that year are taken into account in computing the corporation's taxable income, but not taken into account by the shareholders.

Explanation of Provision

The provision allows a bank which changes from the reserve method of accounting for bad debts for its first taxable year for which it is an S corporation to elect to take into account all adjustments under section 481 by reason of the change in the last taxable year it was a C corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 2006.

4. Treatment of sale of an interest in a qualified subchapter S subsidiary

Present Law

Under present law, an S corporation that owns all the stock of a corporation may elect to treat the subsidiary corporation as a qualified subchapter S subsidiary ("QSub"). A qualified subchapter S subsidiary is disregarded as a separate entity for Federal tax purposes and its items of income, deduction, loss, and credit are treated as items of the S corporation.

If the subsidiary corporation ceases to be a QSub (e.g., fails to meet the wholly-owned requirement) the subsidiary is treated as a new corporation acquiring all its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock. Under Treasury regulations,[22] the tax treatment of the termination of the QSub election is determined under general principals of tax law, including the step transaction doctrine. The regulations set forth an example[23] in which an S corporation sells 21 percent of the stock of a QSub to an unrelated party. In the example, the deemed transfer of all the assets to the QSub is treated as a taxable sale because the S corporation was not in control of the QSub immediately after the transfer by reason of the sale, and thus the transfer did not qualify for nonrecognition treatment under section 351.

Explanation of Provision

The provision provides that where the sale of stock of a QSub results in the termination of the QSub election, the sale is treated as a sale of an undivided interest in the assets of the

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[22] Treas. Reg. sec. 1.1361-5(b).

[23] Example (1) of Treas. Reg. sec. 1.1361-5(b)(3).

QSub (based on the percentage of the stock sold) followed by a deemed transfer to the QSub in a transaction to which section 351 applies.

Thus, in the above example, the S corporation will be treated as selling a 21 percent-interest in all the assets of the QSub to the unrelated party, followed by a transfer of all the assets to a new corporation in a transaction to which section 351 applies. Thus, the S corporation will recognize 21 percent of the gain or loss in the assets of the QSub.

The provision is not intended to change the present-law treatment of the disposition of stock of a QSUB by an S corporation in connection with an otherwise non-taxable transaction. For example, the transfer of stock of a QSUB by an S corporation pro rata to its shareholders can qualify as a distribution to which sections 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.[24]

Effective Date

The provision applies to taxable years beginning after December 31, 2006.

5. Elimination of earnings and profits attributable to pre-1983 years

Present Law

The Small Business Jobs Protection Act of 1996 provided that if a corporation was an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year were reduced by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S.

Explanation of Provision

The provision provides in the case of any corporation which was not an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of the first taxable year beginning after the date of the enactment of this provision is reduced by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

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[24] See Example (4) of Treas. Reg. sec. 1.1361-5(b)(3).

6. Deductibility of interest expense of an ESBT on indebtedness incurred to acquire S corporation stock

Present Law

Under present law, an electing small business trust ("ESBT") is subject to a tax at the highest individual income tax rate (currently 35 percent) on the portion of the trust which consists of stock in one or more S corporations ("S portion").[25] The income from the S portion of an ESBT is not included in the beneficiaries' income.

The only items of income, loss, or deduction taken into account in computing the taxable income of the S portion of an ESBT are: (1) the items of income, loss or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the ESBT properly allocable to the S corporation stock. Under Treasury regulations,[26] interest paid by an ESBT to purchase stock in an S corporation is allocated to the S portion of the ESBT but is not a deductible administrative expense for purposes determining the taxable income of the S portion.

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust are disregarded.

Explanation of Provision

The provision provides that a deduction for interest paid or accrued on indebtedness to acquire stock in an S corporation may be taken into account in computing the taxable income of the S portion of an ESBT.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006.

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[25] Sec. 641(c).

[26] Treas. Reg. sec. 1.641(c)-1(d)(4)(ii).

II. REVENUE PROVISIONS

A. Increase in Age of Children Whose Unearned Income is Taxed as if Parents' income (sec. 8241 of the bill and sec. 1(g) of the Code)

Present Law

Special rules (generally referred to as the "kiddie tax") apply to the net unearned income of certain children.[27] Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 18 by the close of the taxable year and either of the child's parents is alive at such time; (2) the child's unearned income exceeds $1,700 (for 2007); and (3) the child does not file a joint return. The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents.

Under these rules, the net unearned income of a child (for 2007, generally unearned income over $1,700) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child.[28] The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $1,700 (for 2007), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts.[29] In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[30]

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($850 for 2007), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[31] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable

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[27] Sec. 1(g).

[28] Special rules apply for determining which parent's rates apply where a joint return is not filed.

[29] Sec. 1(g)(4) and sec. 911(d)(2).

[30] Sec. 1(h).

[31] Sec. 1(g)(4).

income according to the ratio of net unearned income to the child's total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Generally, a child must file a separate return to report his or her income.[32] In such case, items on the parents' return are not affected by the child's income, and the total tax due from the child is the greater of:

1. the sum of (a) the tax payable by the child on the child's earned income and unearned income up to $1,700 (for 2007), plus (b) the allocable parental tax on the child's unearned income, or

2. the tax on the child's income without regard to the kiddie tax provisions.

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return.

Explanation of Provision

The provision expands the kiddie tax to apply to children who are 18 years old or who are full-time students over age 18 but under age 24. The expanded provision applies only to children whose earned income does not exceed one-half of the amount of their support.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

[32] In cases where the kiddie tax applies, the child must attach to the return Form 8615, Tax for Children Under Age 18 With Investment Income of More Than $1,700 (2006).

B. Suspension of Penalties and Interest (sec. 8242 of the bill and sec. 6404(g) of the Code)

Present Law

In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. The Code suspends the accrual of certain penalties and interest starting 18 months after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. If the return is filed before the due date, for this purpose it is considered to have been filed on the due date. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension applies only to taxpayers who are individuals and who file a timely tax return. In addition, the provision does not apply to the failure-to-pay penalty, in the case of fraud, or with respect to criminal penalties. Generally, the provision also does not apply to interest accruing with respect to underpayments resulting from listed transactions or undisclosed reportable transactions.

Explanation of Provision

The provision extends the period before which accrual of interest and certain penalties are suspended. Under the provision, the accrual of certain penalties and interest is suspended starting 36 months after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability.

Effective Date

The provision is effective for IRS notices issued after the date that is six months after the date of enactment.

C. Modification of Collection Due Process Procedures for Employment Tax Liabilities (sec. 8243 of the bill and sec. 6330 of the Code)

Present Law

Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property. A Federal tax lien arises automatically when (1) a tax assessment has been made, (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment, and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial collection due process ("CDP") hearing before levy may be made on any property or right to property.[33] Similar rules apply with respect to notices of tax liens, although the right to a hearing arises only on the filing of a notice.[34] The CDP hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. Under present law, taxpayers are not entitled to a pre-levy CDP hearing if a levy is issued to collect a Federal tax liability from a State tax refund or if collection of the Federal tax is in jeopardy. However, levies related to State tax refunds or jeopardy determinations are subject to post-levy review through the CDP hearing process.

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and the requirement that employers withhold income taxes from wages paid to employees ("income tax withholding").[35] Income tax withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Explanation of Provision

Under the provision, a levy issued to collect Federal employment taxes is excepted from the pre-levy CDP hearing requirement if the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. However, the taxpayer is provided an opportunity for a hearing within a reasonable period of

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[33] Sec. 6330(a).

[34] Sec. 6320.

[35] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). FICA taxes consist of an employer share and an employee share, which the employer withholds from employees' wages.

time after the levy. As the Code provides for State tax refunds or jeopardy determinations, collection by levy of employment tax liabilities is permitted to continue during the CDP proceedings.

Effective Date

The provision is effective for levies issued on or after the date that is 120 days after the date of enactment.

D. Permanent Extension of IRS User Fees
(sec. 8244 of the bill and sec. 7528 of the Code)

Present Law

The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[36] These user fees are authorized by statute through September 30, 2014.

Explanation of Provision

The provision permanently extends the statutory authorization for IRS user fees.

Effective Date

The provision is effective for requests made after the date of enactment.

[36] Sec. 8228.

E. Increase in Penalty for Bad Checks and Money Orders (sec. 8245 of the bill and sec. 6657 of the Code)

Present Law

The Code[37] imposes a penalty on a person who tenders a bad check or money orders. The penalty is two percent of the amount of the bad check or money order. For checks or money orders that are less than $750, the minimum penalty is $15 (or, if less, the amount of the check or money order).

Explanation of Provision

The provision increases the minimum penalty to $25 (or, if less, the amount of the check or money order), applicable to checks or money orders that are less than $1,250.

Effective Date

The provision is effective with respect to checks or money orders received after the date of enactment.

[37] Sec. 6657.

F. Understatement of Taxpayer's Liability by Tax Return Preparers (sec. 8246 of the bill and secs. 6694 and 7701 of the Code)

Present Law

An income tax return preparer is defined as any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[38] Under present law, the definition of an income tax return preparer does not include a person preparing non-income tax returns, such as estate and gift, excise, or employment tax returns.

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits, or a frivolous position, is liable for a first-tier penalty of $250, provided the preparer knew or reasonably should have known of the position.[39] For purposes of the penalty, an understatement is generally defined as any understatement with respect to any tax imposed by subtitle A (i.e., income taxes). An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing an income tax return is liable for a second-tier penalty of $1,000.

Explanation of Provision

The provision broadens the scope of the present-law tax return preparer penalties to include preparers of estate and gift tax, employment tax, and excise tax returns, and returns of exempt organizations.

The provision also alters the standards of conduct that must be met to avoid imposition of the penalties for preparing a return with respect to which there is an understatement of tax. First, the provision replaces the realistic possibility standard for undisclosed positions with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The provision replaces the not-frivolous standard accompanied by disclosure with the requirement that there be a reasonable basis for the tax treatment of the position accompanied by disclosure.

The provision also increases the first-tier penalty from $250 to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty is imposed. The provision increases the second-tier penalty from $1,000 to the greater of $5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer.

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[38] Sec. 7701(a)(36)(A).

[39] Sec. 6694.

Effective Date

The provision is effective for tax returns prepared after the date of enactment.

G. Penalty for Filing Erroneous Refund Claims (sec. 8247 of the bill and sec. 6662 of the Code)

Present Law

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[40] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Explanation of Provision

The provision imposes a penalty on any taxpayer filing an erroneous claim for refund or credit. The penalty is equal to 20 percent of the disallowed portion of the claim for refund or credit for which there is no reasonable basis for the claimed tax treatment. The penalty does not apply to any portion of the disallowed portion of the claim for refund or credit relating to the earned income credit or any portion of the disallowed portion of the claim for refund or credit that is subject to accuracy-related or fraud penalties.

Effective Date

The provision is effective for claims for refund or credit filed after the date of enactment.

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[40] Sec. 6662(b)(3) and (h).

H. Time for Payment of Corporate Estimated Tax (sec. 8248 of the bill)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15. Fiscal year taxpayers make quarterly payments on corresponding dates.

The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") provided that in the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012 (for fiscal and calendar year taxpayers, respectively) are increased to 106.25 percent of the payment otherwise due and the next required payment is reduced accordingly.

Explanation of Provision

The provision increases the corporate estimated tax payments due in July, August, and September, 2012, from 106.25 percent to 114.25 percent of the payment otherwise due. As under present law, the next payment is reduced accordingly.

Effective Date

The provision is effective on the date of enactment.

III. PENSION RELATED PROVISIONS

A. Revocation of Election Relating to Treatment as Multiemployer Plan (sec. 6611 of the bill and sec. 414(f) of the Code)

Present Law

A multiemployer plan means a plan (1) to which more than one employer is required to contribute; (2) which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer; and (3) which satisfies such other requirements as the Secretary of Labor may prescribe.[41] Present law provides that within one year after the date of enactment of the Multiemployer Pension Plan Amendments Act of 1980, a multiemployer plan could irrevocably elect for the plan not to be treated as a multiemployer plan if certain requirements were satisfied.

Pursuant to the Pension Protection Act of 2006, certain multiemployer plans are permitted under the Code to revoke an existing election not to treat the plan as a multiemployer plan if, for each of the three plan years prior to the date of enactment, the plan would have been a multiemployer plan, but for the election in place.[42] The revocation must be pursuant to procedures prescribed by the Pension Benefit Guaranty Corporation ("PBGC"). In the case of a plan to which more than one employer is required to contribute and which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer (collectively the "criteria"), such plan may, pursuant to procedures prescribed by the PBGC, elect to be a multiemployer plan if (1) for each of the three plan years prior to the date of enactment, the plan has met the criteria; (2) substantially all of the plan's employer contributions for each of those plan years were made or required to be made by organizations that were tax-exempt; and (3) the plan was established prior to September 2, 1974. Such a revocation election is also available in the case of a plan that was established in Chicago, Illinois, on August 12, 1881, and is sponsored by an organization described in Code section 501(c)(5). An election made under the provision is effective beginning with the first plan year ending after the date of enactment of the Pension Protection Act of 2006 (i.e., August 17, 2006) and is irrevocable.

Explanation of Provision[43]

The provision modifies the effective date of the election provided under the Code. Under the provision, a plan may elect an effective date that is any plan year beginning on or after January 1, 1999, and ending before January 1, 2008. The provision also modifies the time period during which the plan must have satisfied the criteria for the election. Under the provision, the

[41] Code sec. 414(f).

[42] Code sec. 414(f)(6).

[43] Provisions similar to those in the Code are contained in section 3(37) of the Employee Retirement Income Security Act of 1974 ("ERISA"). The bill makes corresponding changes to ERISA.

criteria must have been satisfied for each of the three plan years immediately preceding the first plan year for which the election is effective with respect to the plan. In addition, the provision provides that a plan making the election is treated as maintained pursuant to a collective bargaining agreement if a collective bargaining agreement, expressly or otherwise, provides for or permits employer contributions to the plan by one or more employers that are signatory to such agreement, or participation in the plan by one or more employees of an employer that is signatory to such agreement.

In addition, the provision makes a technical correction to the description of one of the plans that is eligible to make the election. Specifically, the technical correction provides that an election is available in the case of a plan sponsored by an organization which is described in Code section 501(c)(5) and exempt from tax under Code section 501(a) and which was established in Chicago, Illinois, on August 12, 1881.

Effective Date

The provision takes effect as if included in section 1106 of the Pension Protection Act of 2006.

B. Modification of Requirements for Qualified Transfers (secs. 6612 and 6613 of the bill and sec. 420 of the Code)

Present Law

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan ("retiree medical accounts"). Generally, defined benefit plan assets may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. However, section 420 of the Code provides that certain transfers of excess assets of a defined benefit plan to a retiree medical account within the plan may be made in order to fund retiree health benefits. A transfer that qualifies under section 420 does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. No transfer pursuant to section 420 may be made after December 31, 2013.

Prior to the amendment of section 420 by the Pension Protection Act of 2006, transferred assets (and any income thereon) were required to be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Among the requirements for such a transfer to be qualified is the requirement that the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years (referred to as the minimum cost requirement).

Pursuant to changes made by the Pension Protection Act of 2006, section 420 currently permits an employer to elect to make a "qualified future transfer" or a "collectively bargained transfer" rather than a "qualified transfer" (which generally is a transfer described in section 420, prior to amendment by the Pension Protection Act of 2006). A qualified future transfer permits transfers of excess pension assets under a single-employer plan to retiree medical accounts to fund the expected cost of retiree medical benefits for the current and future years. A collectively bargained transfer permits such transfers in the case of benefits provided under a collective bargaining agreement. Transfers must be made for at least a two-year period (referred to as the transfer period). In addition, a qualified future transfer or collectively bargained transfer must meet the requirements applicable to qualified transfers, with certain modifications to the requirements, one of which is the minimum cost requirement.

In the case of a qualified future transfer, the minimum cost requirement is satisfied if, during the transfer period and the four subsequent years, the annual average amount of employer costs is not less than applicable employer cost determined with respect to the transfer. An employer may elect to meet this minimum cost requirement by meeting the requirements as in effect before the amendments made by section 535 of the Tax Relief Extension Act of 1999 for each year during the transfer period and the four subsequent years. In the case of a collectively bargained transfer, the minimum cost requirement is satisfied if each collectively bargained group health plan under which collectively bargained health benefits are provided provides that the collectively bargained employer cost for each taxable year during the collectively bargained cost maintenance period is not less than the amount specified by the collective bargaining agreement. The collectively bargained employer cost is the average cost per covered individual of providing collectively bargained retiree health benefits as determined in accordance with the applicable collective bargaining agreement. Thus, retiree medical benefits must be provided at the level determined under the collective bargaining agreement for the shorter of (1) the remaining lifetime of each covered retiree (and any covered spouse and dependent), or (2) the period of coverage provided under the collectively bargained health plan for such covered retiree (and any covered spouse and dependent).

Explanation of Provision

In the case of a qualified transfer, the provision permits the transfer to satisfy the minimum cost requirement by satisfying the minimum cost requirement applicable to a collectively bargained transfer. This alternate method of satisfying the minimum cost requirement is only available if the transfer involves a plan maintained by an employer, which in its taxable year ending in 2005, provided health benefits or coverage to retirees and their spouses and the aggregate cost of such benefits or coverage which would have been allowable as a deduction to the employer is at least five percent of the gross receipts of the employer for such taxable year (or is a plan maintained by a successor to such employer).

In addition, the provision makes technical corrections to section 420 to correct an internal cross-reference and to reflect the revisions made to the minimum funding requirements applicable to defined benefit plans under the Pension Protection Act of 2006.

Effective Date

The provision is generally effective for transfers after the date of enactment. The technical corrections are effective as if included in the Pension Protection Act of 2006.

C. Extension of Alternative Deficit Reduction Contribution Rules (sec. 6614 of the bill and sec. 402(i) of the Pension Protection Act of 2006)

Present Law

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Code.[44] Prior to the enactment of the Pension Protection Act of 2006, the amount of contributions required for a plan year under the minimum funding rules was generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. Additional contributions were required under the deficit reduction contribution rules in the case of certain underfunded plans.

Under the Pension Protection Act of 2006, these minimum funding rules were replaced by new funding rules. These new rules are generally effective for plan years beginning after December 31, 2007.

Prior to the enactment of the Pension Protection Act of 2006, certain employers ("applicable employers") were permitted to elect a reduced amount of additional required contribution under the deficit reduction contribution rules (an "alternative deficit reduction contribution") with respect to certain plans for applicable plan years. For purposes of the election, an applicable plan year was a plan year beginning after December 27, 2003, and before December 28, 2005, for which the employer elects a reduced contribution. If an employer made such an election, the amount of the additional deficit reduction contribution for an applicable plan year was the greater of: (1) 20 percent of the amount of the additional contribution that would otherwise be required; or (2) the additional contribution that would be required if the deficit reduction contribution for the plan year were determined as the expected increase in current liability due to benefits accruing during the plan year. An applicable employer included an employer that is a commercial passenger airline.

In the case of an employer which is a commercial passenger airline, the Pension Protection Act of 2006 extends the alternative deficit reduction contribution rules to plan years beginning before December 28, 2007.

Explanation of Provision

The provision extends the alternative deficit reduction contribution rules to plan years beginning before January 1, 2008.

Effective Date

The provision takes effect as if included in section 402 of the Pension Protection Act of 2006.

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[44] Code sec. 412. Similar rules apply to single-employer defined benefit pension plans under ERISA.

D. Modification of the Interest Rate for Pension Funding Rules (sec. 6615 of the bill and sec. 402(a) of the Pension Protection Act of 2006)

Present Law

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Code.[45] The Pension Protection Act of 2006 provides for new minimum funding rules, which are generally effective for plan years beginning after December 31, 2007.

Under the new minimum funding rules, the minimum required contribution to a single-employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. The plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. In general, a plan has a funding shortfall if the plan's funding target for the year exceeds the value of the plan's assets (reduced, if applicable, by any prefunding balance and funding standard carryover balance). If the value of a plan's assets (reduced by any funding standard carryover balance and prefunding balance) is less than the plan's funding target for a plan year, so that the plan has a funding shortfall, the minimum required contribution is generally increased by a shortfall amortization charge.

The shortfall amortization charge for a plan year is the aggregate total of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for that plan year and the six preceding plan years. A shortfall amortization base is generally required to be established for a plan year if the plan has a funding shortfall for a plan year. The shortfall amortization base for a plan year is (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments (and, if applicable, waiver amortization installments) that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases (and waiver amortization bases) for preceding plan years. The shortfall amortization installments with respect to a shortfall amortization base for a plan year are the amounts necessary to amortize the shortfall amortization base in level annual installments over the seven-plan-year period beginning with the plan year. The shortfall amortization installment with respect to a shortfall amortization base for any plan year in the seven-year period is the annual installment determined for that year for that shortfall amortization base. Shortfall amortization installments are determined using the appropriate segment interest rates.

The new minimum funding rules specify the interest rates and other actuarial assumptions that must be used in determining a plan's target normal cost and funding target. Under the rules, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period

[45] Code sec. 412. Similar rules apply to single-employer defined benefit pension plans under ERISA.

beginning on the first day of the plan year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. In general, the corporate bond yield curve used for this purpose is to be prescribed on a monthly basis by the Secretary of the Treasury and reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. A special transition rule applies for plan years beginning in 2008 and 2009 (other than for plans first effective after December 31, 2007).

In addition to the new minimum funding rules described above, the Pension Protection Act of 2006 also provided for special funding rules to apply for certain eligible plans. An eligible plan is a single-employer defined benefit pension plan sponsored by an employer that is a commercial passenger airline or the principal business of which is providing catering services to a commercial passenger airline.

The plan sponsor of an eligible plan may make one of two alternative elections. In the case of a plan that meets certain benefit accrual and benefit increase restrictions, an election allowing a 17-year amortization of the plan's unfunded liability is available. In lieu of this election, a plan sponsor may alternatively elect, for the first taxable year beginning in 2008, to amortize the shortfall amortization base for such taxable year over a period of 10 plan years (rather than 7 plan years) beginning with such plan year. Under this alternative election, the benefit accrual and benefit increase restrictions do not apply. This 10-year amortization election must be made by December 31, 2007.

Explanation of Provision

The provision provides that, in the case of a plan sponsor that elects to amortize the shortfall amortization base over a period of 10 plan years, the plan is to use an interest rate of 8.25 percent for purposes of determining the funding target for each of the 10 plan years during such period (instead of the segment rates calculated on the basis of the corporate bond yield curve).

Effective Date

The provision takes effect as if included in section 402 of the Pension Protection Act of 2006.