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HEARTLAND, HABITAT, HARVEST, AND HORTICULTURE ACT OF 2007

OCTOBER 25, 2007.—Ordered to be printed

Mr. BAUCUS, from the Committee on Finance, submitted the following

R E P O R T

[To accompany S. 2242]

The Committee on Finance, having considered an original bill (S. 2242) to amend the Trade Act of 1974 to establish supplemental agricultural disaster assistance and to amend the Internal Revenue Code of 1986 to provide tax incentives for conservation and alternative energy sources and to provide tax relief for farmers, and for other purposes, reports favorably thereon and recommends that the bill do pass.

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69–010

I. LEGISLATIVE BACKGROUND

The Finance Committee has exclusive jurisdiction over tax matters and has previously held hearing and reported legislation that included some of the provisions in this legislation. The Committee anticipates that the Senate may consider adding the substance of this bill to H.R. 2419, the "Farm, Nutrition, and Bioenergy Act of 2007," or similar legislation.

II. EXPLANATION OF THE BILL

TITLE I—SUPPLEMENTAL AGRICULTURAL DISASTER ASSISTANCE FROM THE AGRICULTURE DISASTER RELIEF TRUST FUND [1]

A. Crop Disaster Assistance Program and Other Disaster Assistance

PRESENT LAW

The Farm Service Agency ("FSA") of the United States Department of Agriculture ("USDA") offers various ongoing programs for agricultural producers to facilitate recovery from losses caused by natural events.[2] Ongoing programs include the Emergency Conservation Program ("ECP"), the Noninsured Crop Disaster Assist-

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[1] The description of this provision was supplied by the Majority Staff of the Senate Finance Committee.

[2] For more information see the USDA FSA Ongoing Disaster Assistance Programs for Agricultural Producers Fact Sheet, January 2007 available at http://www.fsa.usda.gov/Internet/FSA_File/ongdisasst07.pdf.

ance Program ("NAP"), the Disaster Debt Set-Aside Program ("DSA"), and the Emergency Loan Program ("EM").

ECP is a discretionary program funded through annual appropriations that provides funding for farmers and ranchers to rehabilitate farmland damaged by natural disaster and for carrying out emergency water conservation measures during severe drought. The natural disaster must create new conservation problems that if untreated would (1) impair or endanger the land; (2) materially affect the productive capacity of the land; (3) represent unusual damage which, except for wind erosion, is not the type likely to recur frequently in the same area; and (4) be so costly to repair that federal assistance is, or will be required, to return the land to productive agricultural use.

NAP provides a low level of insurance to producers who grow otherwise noninsurable crops. NAP provides coverage for crop losses and planting prevented by disasters. Landowners, tenants, or sharecroppers who share in the risk of producing an eligible crop may qualify for this program. Before payments can be issued, applications must first be received and approved, generally before the crop is planted, and the crop must have suffered a minimum of 50 percent loss in yield. Payments are 55 percent of the commodities' average market price on crop losses beyond 50 percent. Eligible crops include commercial crops and other agricultural commodities produced for food, including livestock feed or fiber for which the catastrophic level of crop insurance is unavailable. Also eligible for NAP coverage are controlled-environment crops (mushroom and floriculture), specialty crops (honey and maple sap), and value loss crops (aquaculture, Christmas trees, ginseng, ornamental nursery, and turfgrass sod).

DSA is available to those producers who are borrowers from the Farm Service Agency in primary or contiguous counties that have been declared by the President or designated by the Secretary of Agriculture ("Secretary") as a disaster area. When borrowers affected by natural disasters are unable to make their scheduled payments on any debt, FSA is authorized to consider the set-aside of some payments to allow the farming operation to continue. After a disaster designation is made, FSA will notify borrowers of the availability of the DSA. Borrowers who are notified have eight months from the date of designation to apply. FSA borrowers may also request a release of income proceeds to meet current operating and family living expenses or may request special servicing provisions from their local FSA county offices to explore other options.

EM provides emergency loans to help producers recover from production and physical losses due to drought, flooding, other natural disasters, or quarantine. Emergency loans may be made to farmers and ranchers who own or operate land located in a county declared by the President as a disaster area or designated by the Secretary as a disaster area or quarantine area (for physical losses only, the FSA administrator may authorize emergency loan assistance). EM funds may be used to: (1) restore or replace essential property; (2) pay all or part of production costs associated with the disaster year; (3) pay essential family expenses; (4) reorganize the farming operation; and (5) refinance certain debts.

REASONS FOR CHANGE

Farmers and ranchers can wait years to receive assistance from Congress when faced with a weather-related disaster such as drought, floods or severe storms. The Committee believes that a supplemental agricultural disaster assistance program is appropriate to ensure that farmers have a dependable and timely safety net when disasters strike. The Supplemental Agriculture Disaster Assistance program creates a trust fund that will cover losses not covered by crop insurance. To receive benefits from the trust fund, farmers and ranchers must: (1) carry crop insurance; and (2) be located in a Secretarially declared disaster county or a contiguous county, or show proof of an individual loss of at least 50%. Farmers carrying higher levels of insurance will be eligible for higher payments. Each farmer or rancher applying for supplemental disaster assistance must show that whole farm income from crop production declined due to the loss of a particular crop due to natural disasters. The Committee believes that these additional accountability measures will encourage farmers to participate in crop insurance programs, and will target assistance to those farmers and ranchers with the greatest need. The Committee believes that Supplemental Disaster Assistance program will be particularly useful to beginning farmers and ranchers who cannot afford to wait years for disaster assistance and do not have the equity to handle large scale crop losses due to natural disasters.

The Committee believes that the creation of a trust fund, funded through an allocation of tariff revenues, is the appropriate mechanism to support this program. An amount equal to 3.34% of revenues from all tariffs will be transferred to the trust fund through December 31, 2012. Payments from the trust fund could begin in crop year 2008. The creation of the trust fund was modeled after Section 32 of the Act of August 24, 1935 (7 U.S.C. 612c), which sets aside a percentage of tariff revenues for nutrition and other programs that broadly benefit all sectors of U.S. agriculture.

EXPLANATION OF PROVISION

In general

The provision amends the Trade Act of 1974 to create an Agriculture Disaster Relief Trust Fund ("ADTF") that would provide payments to farmers and ranchers who suffer losses in areas that are declared disaster areas by the USDA. The trust fund will be funded by an amount equal to 3.34 percent of the amounts received in the general fund of the Treasury that are attributable to the duties collected on articles entered, or withdrawn from warehouse, for consumption under the Harmonized Tariff Schedule. The ADTF could make payments under four new disaster assistance programs: the crop disaster assistance program, the livestock indemnity program, the tree assistance program, and the emergency assistance program for livestock, honey bees, and farm raised fish. In addition, the ADTF will also fund a new pest and disease management and disaster prevention program. Amounts not required to meet current withdrawals may be invested in U.S. Treasury obligations with interest credited to the ADTF. The ADTF may also borrow, with interest, as repayable advances sums necessary to carry out the purposes of the fund.

Crop Disaster Assistance Program ("CDAP")

Generally, CDAP payments will be paid to producers located in disaster counties on 52 percent of the difference between the disaster program guarantee and the sum of total farm revenue. Disaster counties include counties receiving disaster declarations by the Secretary due to production losses resulting directly or indirectly from adverse weather, counties contiguous to such counties, and any farm whose production due to weather was less than 50 percent of normal production. To be eligible for CDAP payments, the producer must have purchased or enrolled in both crop insurance for insurable crops at a minimum of 50 percent of yield at 55 percent of price and NAP for uninsurable crops. The Secretary may waive this requirement under certain conditions.

The disaster program guarantee for insurable crops is equal to the product of a measure of crop yield, the percentage of crop insurance yield guarantee, the percentage of crop insurance price elected by the producer, the crop insurance price, and 115 percent. The disaster program guarantee for noninsured crops is equal to the product of the yield as determined by NAP for each crop, 100 percent of the NAP established price, and 115 percent. The disaster program guarantee is the sum of the disaster program guarantee for insurable and noninsured crops.

Total farm revenue includes the sum of the estimated value of crops and grazing, crop insurance and NAP indemnities accruing to the farm, the value of prevented planting payments, the amount of other natural disaster assistance payments provided by the federal government to a farm for the same loss, and an amount equal to 20 percent of any direct payments made to the producer under section 1103 of the Farm Security and Rural Investment Act of 2002. The estimated value of crops is generally the product of actual crop acreage grazed or harvested, estimated actual yields of grazing land or crop production, and the average market price during the first five months of the marketing year in which a farm or portion of a farm is located.

Livestock Indemnity Program

The ADTF may also make payments under the livestock indemnity program to eligible producers on farms that have incurred livestock death losses in excess of normal mortality rates during the calendar year due to adverse weather, as determined by the Secretary. Indemnity payments are made at a rate of 75 percent of the fair market value of the livestock on the day before the date of death of the livestock as determined by the Secretary.

Tree Assistance Program

The Secretary shall make payments to eligible orchardists as follows. Assistance is in the form of (1) 75 percent reimbursement for the cost of replanting trees lost due to a natural disaster if tree mortality is in excess of 15 percent, adjusted for normal mortality, or sufficient seedlings to reestablish a stand; and (2) 50 percent reimbursement of the cost of pruning, removal, and other costs incurred to salvage existing trees or to prepare land to replant trees lost due to a natural disaster in excess of 15 percent damage or mortality adjusted for normal tree damage and mortality.

Buy-up NAP Coverage

Under NAP, FSA compensates eligible producers for losses of noninsurable crops exceeding 50 percent of the expected yield based on 55 percent of the average market price of the commodity. This provision permits producers to buy additional NAP coverage. Producers could purchase additional coverage guarantee up to 60 or 65 percent, as elected by the producers, of expected yield, and up to 100 percent of the average market price of the commodity. Fees would be established and collected by the Secretary to fully offset the cost of supplemental NAP coverage.

Emergency Assistance for livestock, honey bees, and farm-raised fish

The Secretary shall use up to $35,000,000 annually from the trust fund to provide emergency relief to producers of livestock (including horses), honey bees, and farm-raised fish due to losses from adverse weather or other environmental conditions, such as blizzards and wildfires, as determined by the Secretary, that are not covered under the authority of the Secretary to make qualifying natural disaster declarations. For purposes of the provision, farm-raised fish includes the propagation and rearing of aquatic species (including any species of finfish, mollusk, crustacean, or other aquatic invertebrate, amphibian, reptile, or aquatic plant) in controlled or semi-controlled environments.

Limitations

No eligible producer may receive more than $100,000 annually in total disaster assistance under this Act. A producer is not eligible for benefits under the provision if, as determined by the Secretary, such producer's adjusted gross income (as defined in section 1001D(a) of the Food Security Act of 1985 [3] or any successor provision) exceeds $2.5 million, unless not less than 75 percent of the average adjusted gross income of such producer is derived from farming, ranching or forestry operations.

Pest and Disease Management and Disaster Prevention

The provision also establishes a new program under which USDA will conduct early pest detection and surveillance activities in coordination with State departments of agriculture, will prioritize and create action plans to address pest and disease threats to specialty crops, and will create an audit-based certification approach to protect against the spread of plant pests.

Sunset of provision

The authority provided by the provision shall be effective only for losses that are incurred as a result of a disaster, adverse weather, or another environmental condition that occurs on or before September 30, 2012, as determined by the Secretary.

EFFECTIVE DATE

The provision is effective on the date of enactment.

[3] 7 U.S.C. sec. 1308–3a(a).

TITLE II—CONSERVATION PROVISIONS

A. Provide Tax Credit for Eligible Farmland Enrolled in the Conservation Reserve Program

(Sec. 201 of the bill and sec. 30D of the Code)

PRESENT LAW

The Department of Agriculture administers various programs designed to encourage conservation. Under the conservation reserve program,[4] eligible producers generally enter into contracts under which they agree to establish long-term, resource conserving covers on eligible farmland in exchange for annual contract payments.

Present law does not provide an income tax credit for eligible farmland enrolled in the conservation reserve program.

REASONS FOR CHANGE

The Committee believes additional incentives should be provided to encourage eligible producers to establish long-term, resource conserving covers on eligible farmland.

DESCRIPTION OF PROVISION

In general, the provision establishes as a credit against income taxes the conservation reserve credit. The credit is elective, but a taxpayer may not claim the credit for a particular year if the taxpayer receives a contract payment from the Department of Agriculture pursuant to the conservation reserve program for such year.

The conservation reserve credit requires the taxpayer to be an eligible producer on eligible farmland enrolled in the conservation reserve program. The credit is equal to the rental value of any such property enrolled in the program, as determined by the Secretary in consultation with the Secretary of Agriculture. The Secretary may not allocate more than $50,000 of conservation reserve credit to any one taxpayer for any fiscal year. The credit is not includable in the taxpayer's gross income and is not subject to Self-Employment Contributions Act (SECA) tax.

The credit allowed under the provision is taken into account after other credits (sections 21–27, 30, 30B, and 30C) and may not offset the alternative minimum tax. A taxpayer is not entitled to a deduction for any amount with respect to which a credit is allowed under the proposal. In the event a taxpayer terminates a conservation reserve program contract, the Secretary may recapture a portion of the credit corresponding to the portion of the taxable year during which the contract was not in effect.

The provision establishes an annual conservation reserve credit limitation of $750 million for each of fiscal years 2009 through 2012, which represents the total amount of credits that may be allocated under the program for all taxpayers for such years. Unallocated amounts with respect to any calendar year are carried forward to the allowable allocation for the next calendar year, except that no amount of conservation reserve credit may be allocated

[4] The term "conservation reserve program" means the conservation reserve program established under subchapter B of chapter 1 of subtitle D of title XII of the Food Security Act of 1985.

to any taxpayer after fiscal year 2012. The credit allowed under the provision may not exceed the excess of the amount allocated to the taxpayer by the Secretary of the Treasury, in consultation with the Secretary of Agriculture, for the taxable year and all prior taxable years over the credit allowed for all prior taxable years.

EFFECTIVE DATE

The provision is effective on the date of enactment and applies with respect to conservation reserve program contracts entered into before, on, or after such date.

B. Exclusion of Conservation Reserve Program Payments From SECA Tax for Individuals Receiving Social Security Retirement or Disability Payments

(Sec. 202 of the bill and sec. 1402(a) of the Code)

PRESENT LAW

Generally, the Self-Employment Contributions Act ("SECA") tax is imposed on an individual's net earnings from self-employment income within the social security wage base. Net earnings from self-employment generally mean gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions.[5]

REASONS FOR CHANGE

The Committee believes that the correct measurement of income for SECA purposes in the cases of retired or disabled individuals does not include conservation reserve program payments.

EXPLANATION OF PROVISION

The provision excludes conservation reserve program payments from self-employment income for purpose of SECA tax in the case of individuals who are receiving social security retirement or disability benefits. The treatment of conservation reserve program payments received by other entities is not changed.

EFFECTIVE DATE

The provision is effective for payments made after December 31, 2007.

C. Make Permanent the Special Rule Encouraging Contributions of Capital Gain Real Property for Conservation Purposes

(Sec. 203 of the bill and sec. 170 of the Code)

PRESENT LAW

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount

[5] Sec. 1402.

of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[6]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are

[6] Secs. 170, 2055, and 2522, respectively. Unless otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

Special rule regarding contributions of capital gain real property for conservation purposes

In general

Under a temporary provision that is effective for contributions made in taxable years beginning after December 31, 2005,[7] the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50-percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the non-conservation contributions (50 percent of the $100 contribution

[7] Sec. 170(b)(1)(E).

base) and is allowed to carry over the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified conservation contribution is allowed and $30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[8]

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made on or before August 17, 2006.

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Termination

The special rule regarding contributions of capital gain real property for conservation purposes does not apply to contributions made in taxable years beginning after December 31, 2007.

REASONS FOR CHANGE

Gifts of conservation easements to organizations that are dedicated to maintaining natural habitats, open spaces, or traditional agriculture help protect our nation's heritage. The charitable tax deduction for such conservation easements has proven to be a valuable incentive for making such gifts. The Committee believes that the special rule that provides an increased incentive to make charitable contributions of partial interests in real property for con-

[8] Sec. 170(b)(2)(B).

servation purposes is an important way of encouraging conservation and preservation, and should be made permanent.

EXPLANATION OF PROVISION

The provision makes permanent the special rule regarding contributions of capital gain real property for conservation purposes.

EFFECTIVE DATE

The provision is effective for contributions made in taxable years beginning after December 31, 2007.

D. PROVIDE TAX CREDIT FOR RECOVERY AND RESTORATION OF ENDANGERED SPECIES

(Sec. 204 of the bill and new sec. 30D of the Code)

PRESENT LAW

Present law does not provide an income tax credit for endangered species recovery expenditures.

REASONS FOR CHANGE

The Endangered Species Act ("ESA") of 1973 is a comprehensive attempt to protect species at risk of extinction and to consider habitat protection as an integral part of that effort. The purpose of the ESA is to conserve the ecosystems upon which endangered and threatened species depend and to conserve and recover listed species. Under the ESA, species of plants and animals (both vertebrate and invertebrate) may be listed as either endangered or threatened according to assessments of the risk of their extinction.

As of September 20, 2007, according to the U.S. Fish and Wildlife Service ("USFWS"), a total of 607 species of animals and 744 species of plants had been listed as either endangered or threatened in the United States and its territories. According to the USFWS, over 70 percent of the nation's landscape is in private ownership and nearly two-thirds of Federally listed endangered and threatened species are found on private lands. With such a large number of the country's listed species dependent upon private lands for their survival, and many exclusively so, the goals of the ESA cannot be accomplished without the Federal government becoming involved to provide incentives for species protection on private lands. For both plants and animals, the ESA has very few provisions for restoration and managing habitats on private lands. Many important habitats require restoration and management because, among other things, they have been overrun by invasive species or have been deprived of fire and other natural processes.

Although the ESA prohibits landowners from harming endangered or threatened species, the Act itself contains only a small number of incentives for landowners to undertake the beneficial management actions that most species require for recovery. In addition, while most private landowners care about their land and want to practice good stewardship, they often lack the time and resources to deal with complex regulations and necessary management activities.

The Committee believes that tax credits for private landowners who undertake habitat protection and restoration for endangered species will provide some needed incentives to help recover threatened and endangered species.

EXPLANATION OF PROVISION

In general

For eligible taxpayers, the provision establishes a credit against income taxes for: (1) costs paid or incurred by an eligible taxpayer for the taxable year (reduced by the amount of government financing for conservation of a qualified species, and not including costs required by a Federal, State, or local government) pursuant to a habitat management plan entered into under certain qualified habitat protection agreements ("habitat restoration credit") and (2) a percentage of the loss in value to real property attributable to an easement placed on the property pursuant to such agreements (less any amount received in connection with the easement) ("habitat protection easement credit"). The allowable credit amount is 100 percent of costs paid or incurred and the loss in value to property pursuant to qualified perpetual habitat protection agreements; 75 percent of costs paid or incurred and the loss in value to property pursuant to qualified 30-year habitat protection agreements; and 50 percent of costs paid or incurred pursuant to a qualified habitat protection agreement.

For purposes of the habitat protection easement credit, the loss in value is the difference between the fair market value of the real property subject to the agreement determined on the day before the agreement is entered into less the fair market value of such property determined one day after the agreement is entered into. To claim such credit, the eligible taxpayer must own the real property with respect to which the easement is placed, and include on the tax return for the taxable year a qualified appraisal (within the meaning of section 170(f)(11)(E)) of the real property. The taxpayer's basis in such property is reduced by the amount of basis allocated to the easement under regulations prescribed by the Secretary.[9]

The habitat restoration credit is taken into account after other credits (sections 21–27, 30, 30B, 30C, and the habitat protection easement credit) and may not offset the alternative minimum tax. If such credit is allowed for any expenditure with respect to any property, the increase in the basis of such property that would otherwise result from such expenditure is reduced by the amount of the credit allowed. The habitat protection easement credit is taken into account after other credits (sections 21–27, 30, 30B, and 30C) and such credit may offset the alternative minimum tax. Amounts allowed but in excess of either limitation may be carried forward to the succeeding taxable year. No deduction is allowed for any amount with respect to which a credit is allowed. The Secretary of the Treasury shall by regulations provide for the recapture of the credit if such Secretary determines that the eligible taxpayer has failed to carry out the duties required by the qualified agreement and there are no other available means to remediate such failure.

The sum of the two credits may not exceed the amount allocated to the eligible taxpayer for the calendar year in which the taxpayer's taxable year ends by the Secretary of the Treasury, in con-

[9] See, e.g., Treas. Reg. sec. 1.170A–14(h)(3)(iii).

sultation with the Secretary of the Interior and the Secretary of Commerce, or by the Secretary of the Treasury in consultation with the Secretary of Agriculture. If the amount allowed as a credit exceeds the amount allocated for such year, the excess may be carried forward to the next taxable year for which the taxpayer has received an allocation. If the amount allocated to a taxpayer for a calendar year exceeds the amount allowed as a credit for such year, the difference may be carried forward to the next taxable year and treated as allocated to the taxpayer for use in such year. No credit is allowed unless the appropriate Secretary certifies that a qualified agreement will contribute to the recovery of a qualified species.

The aggregate amount allocated by the Secretary of the Treasury, in consultation with the Secretary of the Interior and the Secretary of Commerce may not exceed in each year 2008 through 2012: $290,000,000 with respect to qualified perpetual habitat protection agreements, $55,000,000 with respect to qualified 30-year habitat protection agreements, and $35,000,000 with respect to qualified habitat protection agreements. The aggregate amount allocated by the Secretary of the Treasury, in consultation with the Secretary of Agriculture may not exceed in each year 2008 through 2012: $5,000,000 with respect to qualified perpetual habitat protection agreements, $2,000,000 with respect to qualified 30-year habitat protection agreements, and $1,000,000 with respect to qualified habitat protection agreements. No allocation is allowed after 2012, except that unallocated amounts with respect to any calendar year are carried forward to the allowable allocation for the next calendar year.

Not later than 180 days after the date of enactment, the Secretary of the Treasury, in consultation with the Secretary of the Interior and the Secretary of Commerce, shall by regulation establish a program to process applications from eligible taxpayers and to determine how best to allocate the credit. In allocating the credit, priority shall be given to taxpayers with agreements (1) relating to habitats that will significantly increase the likelihood of recovering and delisting a species as an endangered species or a threatened species (as defined under section 2 of the Endangered Species Act of 1973), (2) that are cost-effective and maximize the benefits to a qualified species per dollar expended, (3) relating to habitats of species that have a Federally approved recovery plan pursuant to section 4 of the Endangered Species Act of 1973, (4) relating to habitats with the potential to contribute significantly to the improvement of the status of a qualified species, (5) relating to habitats with the potential to contribute significantly to the eradication or control of invasive species that are imperiling a qualified species, (6) with habitat management plans that will manage multiple qualified species, (7) with habitat management plans that will create adjacent or proximate habitat for the recovery of a qualified species, (8) relating to habitats for qualified species with an urgent need for protection, (9) with habitat management plans that assist in preventing the listing of a species as endangered or threatened under the Endangered Species Act of 1973 or a similar State law, (10) with habitat management plans that may resolve conflicts between the protection of qualified species and otherwise lawful human activities, and (11) with habitat management plans that may resolve conflicts between the protection of a qualified species and military training or other military operation.

The Secretary of the Treasury shall request that the appropriate Secretary consider whether to authorize under the Endangered Species Act of 1973 takings by an eligible taxpayer of a qualified species to which a qualified agreement relates if the takings are incidental to (1) the restoration, enhancement, or management of the habitat pursuant to the habitat management plan under the agreement or (2) the use of the property to which the agreement pertains at any time after the expiration of the easement (or specified period of time pursuant to a qualified habitat protection agreement), but only if such use will leave the qualified species at least as well off on the property as it was before the agreement was made. Both types of incidental takings currently are authorized under section 10(a)(1) of the Endangered Species Act of 1973 (enhancement of survival permits) and 50 C.F.R. part 17 (safe harbor permits).

The Comptroller General of the United States shall undertake a study on the effectiveness of the credits. Such study shall evaluate the effectiveness of the credits in encouraging landowners to enter into agreements for the protection of the habitats of endangered and threatened species, and the degree to which such agreements are effective in preserving the habitats of such species and assisting in the recovery of such species, and shall include recommendations for improving the effectiveness of the credits. The Comptroller General shall issue an interim report based on such study within three years of the date of enactment and a final report within five years of such date.

Definitions

Eligible taxpayer

An eligible taxpayer is (1) a taxpayer who owns real property that contains habitat of a qualified species and enters into a qualified perpetual habitat protection agreement, a qualified 30-year habitat protection agreement, or a qualified habitat protection agreement with the appropriate Secretary with respect to such real property, and (2) a taxpayer who is a party to a qualified perpetual habitat protection agreement, a qualified 30-year habitat protection agreement, or a qualified habitat protection agreement and, as part of any such agreement, agrees to assume responsibility for costs paid or incurred as a result of implementing such agreement.

Qualified agreements

A qualified perpetual habitat protection agreement is an agreement under which an easement is granted to the appropriate Secretary, the Secretary of Agriculture, the Secretary of Defense, or a State to protect the habitat of a qualified species in perpetuity. A qualified 30-year habitat protection agreement is an agreement under which an easement is granted to the appropriate Secretary, the Secretary of Agriculture, the Secretary of Defense, or a State to protect the habitat of a qualified species for a period of not less than 30 years and less than perpetuity. A qualified habitat protection agreement requires agreement with the appropriate Secretary, the Secretary of Agriculture, the Secretary of Defense, or a State to protect the habitat of a qualified species for a specified period of time.

In addition, each of the three types of qualified agreement must meet the following requirements: (1) the agreement must be consistent with any recovery plan that is applicable and that has been approved for a qualified species under section 4 of the Endangered Species Act of 1973; (2) the agreement must include a habitat management plan agreed to by the appropriate Secretary and the eligible taxpayer; and (3) the agreement must require that technical assistance with respect to the duties under the habitat management plan be provided to the taxpayer by the appropriate Secretary or an entity approved by the appropriate Secretary.

Habitat management plan

A habitat management plan means, with respect to any habitat, a plan that (1) identifies one or more qualified species to which the plan applies; (2) is designed to restore or enhance the habitat of a qualified species or reduce threats to a qualified species through the management of the habitat; (3) describes the threats to the qualified species that are intended to be reduced through the plan; (4) describes the management practices to be undertaken by the taxpayer; (5) provides a schedule of deadlines for undertaking such management practices; (6) requires monitoring of the management practices and the status of the qualified species; and (7) describes the technical assistance to be provided to the taxpayer and identifies the entity that will provide such assistance.

Qualified species

A qualified species is any species listed as an endangered species or threatened species under the Endangered Species Act of 1973 or any species for which a finding has been made under section 4(b)(3) of the Endangered Species Act of 1973 that listing under such Act may be warranted.

Taking

A taking has the meaning given to such term under the Endangered Species Act of 1973.

Appropriate Secretary

Appropriate Secretary has the meaning given to the term "Secretary" under section 3(15) of the Endangered Species Act of 1973.

EFFECTIVE DATE

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

E. Deduction for Endangered Species Recovery Expenditures

(Sec. 205 of the bill and sec. 175 of the Code)

PRESENT LAW

Under present law, a taxpayer engaged in the business of farming may treat expenditures that are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention or erosion of land used in farming, as expenses that are not chargeable to capital account. Such expenditures are allowed as a deduction, not to exceed 25 percent of the gross income derived from farming during the taxable year.[10] Any excess above such percentage is deductible for succeeding taxable years, not to exceed 25 percent of the gross income derived from farming during such succeeding taxable year.

REASONS FOR CHANGE

The goal of the Endangered Species Act of 1973 is to recover listed species and the ecosystems on which they depend to levels where protection under such Act is no longer necessary. Recovery is the process by which the decline of an endangered species is arrested or reversed, and threats removed or reduced so that the species' long-term survival in the wild can be ensured. Section 4(f)(1) of such Act directs the appropriate Secretary to develop and implement recovery plans for the conservation and survival of endangered and threatened species, unless the appropriate Secretary finds that such a plan will not promote the conservation of the species. To the maximum extent practicable, the recovery plan must incorporate a description of management actions to achieve the plan's goals, objective and measurable criteria for determining the removal of species from the endangered species list, and estimate the time required and cost to carry out the recovery plan. The appropriate Secretary may procure the services of appropriate private and public agencies in developing and implementing a recovery plan.

According to an April 6, 2006, General Accountability Office report entitled "Endangered Species: Time and Costs to Recover Species Are Largely Unknown", as of January 2006, the Fish and Wildlife Service and the National Marine Fisheries Service had finalized and approved 558 recovery plans covering 1,049 species, or about 82 percent of the 1,272 endangered or threatened species protected in the United States at that time. Recovery plans contain management measures that landowners can adopt on their land that will aid in the recovery of endangered or threatened species, resulting in a public benefit. Such are similar to measures undertaken for soil and water conservation, which are entitled to a tax deduction. The Committee believes that certain expenses of farmers made pursuant to a recovery plan under the Endangered Species Act should be treated similarly to expenditures by farmers made for soil and water conservation.

EXPLANATION OF PROVISION

The provision provides that expenditures paid or incurred by a taxpayer engaged in the business of farming for the purpose of achieving site-specific management actions pursuant to the Endangered Species Act of 1973[11] to be treated the same as expenditures for the purpose of soil or water conservation in respect of land used in farming, or for the prevention or erosion of land used in farming, i.e., such expenditures are treated as not chargeable to capital account and are deductible subject to the limitation that the deduc-

[10] Sec. 175.
[11] 16 U.S.C. 1533(f)(B).

tion may not exceed 25 percent of the farmer's gross income derived from farming during the taxable year.

EFFECTIVE DATE

The provision is effective for expenditures paid or incurred after the date of enactment.

F. Provide Exclusion for Certain Payments and Programs Relating to Fish and Wildlife

(Sec. 206 of the bill and sec. 126 of the Code)

PRESENT LAW

Under present law, gross income does not include the excludable portion of payments made to taxpayers by the Federal and State governments for a share of the cost of improvements to property under certain conservation programs.[12]

The excludable portion is the portion (or all) of a payment made under such programs that is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, and is determined by the Secretary of the Treasury as not increasing substantially the annual income derived from the property. The excludable portion does not include that portion of any payment that is properly associated with an amount that is allowable as a deduction for the taxable year in which such amount is paid or incurred.

Applicable conservation programs include (1) the rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act, (2) the rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977, (3) the water bank program authorized by the Water Bank Act, (4) the emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978, (5) the agriculture conservation program authorized by the Soil Conservation and Domestic Allotment Act, (6) the great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act, (7) the resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act, (8) the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978, (9) any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in items (1) through (8), and (10) any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

[12] Sec. 126.

REASONS FOR CHANGE

Currently, there are a few Federal programs aimed at encouraging landowners to protect and aid in the recovery of endangered or threatened species. Partners for Fish and Wildlife is a national voluntary cost-share program implemented by the U.S. Fish and Wildlife Service to protect, enhance, and restore important fish and wildlife habitats on private lands through partnerships with landowners. The Landowner's Incentive Program provides funding for states to staff their programs and to fund conservation work with private landowners to restore and maintain habitat for endangered, threatened, and other imperiled species. State Wildlife Grant funds are used to address species and their habitats that are identified in State Comprehensive Wildlife Conservation Plans/Strategies (also known as Wildlife Action Plans). Priority for use of these funds is on those species of greatest conservation need. The Private Stewardship Grant Program provides Federal grants on a competitive basis to individuals and groups engaged in voluntary conservation efforts on private lands that benefit Federally listed endangered or threatened species, candidate species or other at-risk species. Private landowners and groups working with private landowners are able to submit proposals directly to the U.S. Fish and Wildlife Service for funding to support these efforts. Each grant must be matched by at least 10 percent of the total project cost in either non Federal dollars or in-kind contributions. The Healthy Forests Reserve Program is a voluntary program to restore and enhance forest ecosystems to promote the recovery of threatened and endangered species, improve biodiversity and enhance carbon sequestration.

The Committee believes that payments received by taxpayers under the Partners for Fish and Wildlife Program, the Landowner Incentive Program, the State Wildlife Grants Program, the Private Stewardship Grants Program, the Forest Health Protection Program, and the program related to integrated pest management are similar to payments made under other government programs that are excludable from gross income under present law. Accordingly, the Committee believes it is appropriate to extend the present-law exclusion to payments under these programs.

EXPLANATION OF PROVISION

The provision expands the exclusion for the excludable portion of certain payments to include the excludable portion of payments made under the Partners for Fish and Wildlife Program authorized by the Partners for Fish and Wildlife Act, the Landowner Incentive Program, the State Wildlife Grants Program, the Private Stewardship Grants Program authorized by the Fish and Wildlife Act of 1956, the Forest Health Protection Program authorized by the Cooperative Forestry Assistance Act of 1978, and the program related to integrated pest management authorized by section 8(i)(1)(A) of the Cooperative Forestry Act of 1978.

EFFECTIVE DATE

The provision is effective for payments received after the date of enactment.

G. Provide Tax Credit for Easements Made Pursuant to Certain U.S.D.A. Conservation Programs

(Sec. 207 of the bill and sec. 30F of the Code)

PRESENT LAW

The Department of Agriculture administers various programs designed to encourage conservation. Under the wetlands reserve program [13] and the grassland reserve program (referred to herein as the working grassland protection program),[14] land owners generally place conservation easements on real property in exchange for payments from the Department of Agriculture.

Present law does not provide an income tax credit for easements placed on real property pursuant to the wetlands reserve program or the working grassland protection program.

REASONS FOR CHANGE

The Committee believes that additional incentives should be provided to encourage landowners to grant conservation easements on real property pursuant to the wetlands reserve program and the working grassland protection program.

EXPLANATION OF PROVISION

In general, the provision establishes two income tax credits: (1) the wetlands reserve conservation credit; and (2) the working grassland protection credit. The credits are elective, but a taxpayer may not claim the credits if the taxpayer receives a payment for an easement made pursuant to the wetlands reserve program or the working grassland protection program.

The wetlands reserve conservation credit requires the taxpayer to grant to the Secretary of Agriculture an easement pursuant to the wetlands reserve program. The credit is equal to the applicable percentage of the wetlands reserve easement value. The applicable percentage is the excess of 1 over the applicable marginal tax rate assuming that the taxpayer sold the easement on the date the easement is granted to the Secretary of Agriculture. The wetlands reserve easement value is the lesser of: (1) the wetlands reserve geographic area rate for the area in which the real property is located multiplied by the number of acres placed under easement and (2) the amount of the payment the taxpayer otherwise would have received from the Department of Agriculture in exchange for the easement pursuant to the wetlands reserve program. The wetlands reserve geographic area rate is a per-acre rate appropriate for easements made under the wetlands reserve program in the particular geographic area as determined by the Secretary of Treasury in consultation with the Secretary of Agriculture.

The working grassland protection credit requires the taxpayer to grant an easement in perpetuity or for a period not less than 30 years to the Secretary of Agriculture or to a State pursuant to the working grassland protection program. In the case of an easement

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[13] The term "wetlands reserve program" means the wetlands reserve program established under subchapter C of chapter 1 of subtitle D of title XII of the Food Security Act of 1985.

[14] The term "working grassland protection program" means the working grassland protection program established under subchapter C of chapter 2 of subtitle D of Title XII of the Food Security Act of 1985.

in perpetuity, the working grassland protection credit for any taxable year is an amount equal to the applicable percentage of the working grassland easement value. The applicable percentage is the excess of 1 over the applicable marginal tax rate assuming that the taxpayer sold the easement on the date the easement is granted to the Department of Agriculture or a State. The working grassland easement value is the lesser of: (1) the working grassland geographic area rate for the area in which the property is located multiplied by the number of acres placed under easement and (2) the amount of the payment the taxpayer otherwise would have received from the Department of Agriculture pursuant to the working grassland protection program. The working grassland geographic area rate is a per-acre rate appropriate for easements granted under the working grassland protection program in the particular geographic area as determined by the Secretary of Treasury in consultation with the Secretary of Agriculture. In the case of a taxpayer who has entered into an easement of at least 30 years, the amount of the working grassland conservation credit is the lesser of: (1) 30 percent of the amount determined under (1) above; and (2) the amount of the payment the taxpayer otherwise would have received from the Department of Agriculture pursuant to the working grassland protection program.

The credits allowed under the provision are taken into account after other credits (sections 21–27, 30, 30B, and 30C) and may not offset the alternative minimum tax. A taxpayer is not entitled to a deduction for any amount with respect to which a credit is allowed under the provision. The Secretary of Treasury shall by regulations provide for the recapture of the wetlands reserve credit or the working grassland protection credit if the Secretary, in consultation with the Secretary of Agriculture, determines that the taxpayer has failed to carry out the duties of the taxpayer under the terms of the easement and there are no other available means to remediate such failure.

The credit allowed under the provision may not exceed the excess of the amount allocated to the taxpayer by the Secretary of the Treasury, in consultation with the Secretary of Agriculture, for the taxable year and all prior taxable years over the credit allowed for all prior taxable years. The taxpayer's basis in property subject to an easement under the provision is reduced.

The provision establishes a national conservation credit limitation of $1 billion, which represents the aggregate amount of credits that may be allocated under the provision for all taxpayers. The Secretary of Treasury, in consultation with the Secretary of Agriculture, shall allocate the national conservation credit limitation to taxpayers who grant easements under the wetlands reserve program or the working grassland protection program. No amount of national conservation credit limitation may be allocated to any taxpayer after fiscal year 2012.

EFFECTIVE DATE

The provision is effective for easements granted after September 30, 2007, in taxable years ending after such date.

H. Provide for Exempt Facility Bonds for Forest Conservation Activities

(Sec. 208 of the bill and Sec. 142 of the Code)

PRESENT LAW

Tax-exempt bonds

In general

Subject to certain Code restrictions, interest on bonds issued by State and local government generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For this purpose, the term "nongovernmental person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond (sec. 141(e)).

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

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

Qualified private activity bonds generally are subject to restrictions on the use of proceeds for the acquisition of land and existing property. For example, generally no more than 25 percent of the net proceeds of a qualified private activity bond may be used for the acquisition of land. In addition, the term of qualified private activity bonds generally may not exceed 120 percent of the economic life of the property being financed.

Taxation of income from timber harvesting

In general, gross income for Federal income tax purposes means all income from whatever source derived, including gross income derived from a trade or business. An organization exempt from taxation generally is subject to tax on its unrelated business taxable income, generally defined to mean gross income (less deductions) derived from a trade or business, the conduct of which is not substantially related to the exercise or performance of the organization's exempt purposes or functions, that is regularly carried on by the organization. Special unrelated trade or business income rules applicable to the cutting of timber are contained in sections 512(b)(5) and 631. Under these rules, the determination of whether income derived from the cutting of timber constitutes unrelated trade or business income depends upon a variety of factors.

REASONS FOR CHANGE

The Committee believes it is appropriate to provide certain tax incentives to further the goal of permanently setting aside working forests for conservation purposes. The Committee believes that providing tax-exempt financing to nonprofit organizations for the purpose of acquiring forests and forest lands to be dedicated to certain conservation purposes will increase their ability to purchase such properties from commercial owners and operators, and that providing limited exclusions from income tax to such nonprofit organizations will enable them to conduct charitable and conservation activities as they make debt service payments on the bonds.

EXPLANATION OF PROVISION

Overview

In general

The provision establishes a pilot project for forest conservation activities by providing two types of tax benefits available to qualified organizations that acquire forest and forest lands for conservation management. First, the provision provides for the treatment of qualified forest conservation bonds as exempt facility bonds. Second, the provision provides for the exclusion from gross income of income from certain timber harvesting activities conducted by a qualified organization on lands acquired with proceeds from qualified forest conservation bonds.

Qualified organizations

Under the provision, an organization must be a qualified organization to be eligible for the tax-exempt financing benefit, and must be a qualified organization for whom qualified forest conservation bonds have been issued (and remain outstanding as tax-exempt bonds) to be eligible for the income exclusion. In general, under the provision, a qualified organization means a nonprofit organization: (1) substantially all the activities of which are charitable, scientific, or educational, including acquiring, protecting, restoring, managing, and developing forest lands and other renewable resources for the long-term charitable, educational, scientific, and public benefit; (2) that periodically conducts educational programs designed to inform the public of environmentally sensitive forestry management and conservation techniques; (3) whose board satisfies certain board composition requirements designed to ensure that it represents public conservation interests;[15] (4) with governance provisions contained in its bylaws that provide a supermajority vote of at least two-thirds of the members of the board of directors is required to approve and amend the qualified organization's qualified conservation plan; and (5) that upon dissolution, its assets are required to be dedicated to an organization exempt from tax under section 501(c)(3) that is organized and operated for conservation purposes, or to a governmental unit.

Qualified forest conservation bonds

In general

The provision creates a new category of tax-exempt bonds, "qualified forest conservation bonds." For purposes of the Code, qualified forest conservation bonds are treated as exempt facility bonds, and therefore, unless otherwise provided, are governed by the same rules as exempt facility bonds. A qualified forest conservation bond means any bond issued as part of an issue if: (1) 95 percent or more of the net proceeds of such issue are to be used for qualified project costs; (2) such bond is issued for a qualified organization; and (3) such bond is issued within 36 months of the date of enactment of the provision. The maximum aggregate face amount of bonds that may be issued is $1.5 billion.

The bonds are allocated by the Secretary generally as follows: (i) 35 percent for qualified project costs with respect to the cost of acquisition by any qualified organization in the Pacific Northwest region; (ii) 30 percent for qualified project costs with respect to the cost of acquisition by any qualified organization in the Western region; (iii) 17.5 percent for qualified project costs with respect to the cost of acquisition by any qualified organization in the Southeast region; (iv) 17.5 percent for qualified project costs with respect to the cost of acquisition by any qualified organization in the Northeast region.

The term "Pacific Northwest region" means Region 6 as defined by the United States Forest Service of the Department of Agriculture under section 200.2 of title 36, Code of Federal Regulations.

[15] The provision requires that at least 20 percent of the board members be comprised of representatives of the conservation community, and that at least 20 percent of the board members be public officials. Not more than one-third of the board members may be comprised of individuals who have or had (during a prescribed five year period) certain types of financial or contractual relationships with a commercial forest products enterprise. A representative of the conservation community is a person well-known in the community located near the acquired forest land for dedication to the causes of conservation and preservation, and may include a member of the board of an established section 501(c)(3) organization with the primary purpose of conservation or preservation. Such term does not include a public official or a person described above who has or had certain types of financial or contractual relationships with a commercial forest products enterprise.

The term "Western region" means Regions 1, 2, 3, 4, 5, and 10 (as so defined). The term "Southeast region" means Region 8 (as so defined). The term "Northeast region" means Region 9 (as so defined).

If any region has not received a full allocation of its bond limitation amount by the end of the period that is 24 months after the date of enactment, the Secretary may allocate excess amounts to other regions in such manner as the Secretary determines appropriate.

Qualified project costs

Qualified project costs include the cost of acquisition by the qualified organization, from an unrelated person, of forests and forest land that at the time of acquisition or immediately thereafter are subject to a conservation restriction that meets certain requirements.[16] The conservation restriction must: (1) be granted in perpetuity to an unrelated charitable organization (other than a private foundation) that is organized and operated for conservation purposes, or to a governmental unit; (2) protect a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, or preserve open space (including farmland and forest land) pursuant to a clearly delineated Federal, State, or local governmental conservation policy and yield a significant public benefit; (3) obligate the qualified organization to pay the costs incurred by the holder of the conservation restriction in monitoring compliance with such restriction; and (4) require that an increasing level of conservation benefits be provided whenever circumstances allow it.

The issuance of qualified forest conservation bonds generally is subject to the rules applicable to issuance of exempt-facility private activity bonds. However, the issuance of such bonds is not subject to the State volume cap. In addition, the restrictions on acquisition of land and existing property do not apply to such bonds. For purposes of determining the maximum maturity on such bonds, the land and standing timber acquired with the proceeds of the bonds is treated as having an economic life of 35 years.

Exclusion of certain qualified harvesting activity income from tax

Income from qualified harvesting activities

Under the provision, income, gains, deductions, losses, or credits from a qualified harvesting activity conducted by a qualified organization generally are not subject to tax or taken into account for Federal income tax purposes. A qualified harvesting activity means the sale, lease, or harvesting of standing timber: (1) on land owned by a qualified organization that it acquired with proceeds of qualified forest conservation bonds; and (2) pursuant to a qualified conservation plan adopted by the organization. Qualified harvesting activity does not include any sale, lease, or harvesting for any period during which the organization ceases to qualify as a qualified organization.

[16] For this purpose, a person is related to another person if such person bears a relationship to such other person described in section 267(b) (determined without regard to paragraph (9) thereof), or section 707(b)(1), determined by substituting 25 percent for 50 percent for purposes of those determinations. If such other person is a nonprofit organization, a person is related to such nonprofit organization if such person controls directly or indirectly more than 25 percent of the governing body of such nonprofit organization.

Timber cutting and the sale or lease of timber is not a qualified harvesting activity to the extent the timber harvesting or removal exceeds prescribed limits. For this purpose, the average annual area of timber harvested cannot exceed 2.5 percent of the total area of the land acquired with the proceeds of qualified forest conservation bonds; or the quantity of timber removed from such land cannot exceed the quantity that can be removed from such land annually in perpetuity on a sustained-yield basis determined only with respect to such land. Certain deviations from these restrictions are permitted to protect the forest from catastrophic danger, such as by fire or windthrow, or from imminent danger from insect or disease attack.

The amount of income from a qualified harvesting activity that may be excluded from gross income for a taxable year may not exceed the amount used by the qualified organization to make debt service payments during such taxable year for qualified forest conservation bonds.[17] The exclusion of income from a qualified harvesting activity does not apply during any period the organization fails to qualify as a qualified organization, or after the bonds are no longer outstanding or fail to qualify as tax-exempt bonds.

Qualified conservation plan

A qualified conservation plan means a multiple land use plan (a) designed and administered primarily for the purposes of protecting and enhancing wildlife, fish, timber, scenic attributes, recreation, and soil and water quality of the forest and forest land, (b) mandates that conservation of the forest and forest land is the singlemost significant use of the forest and land, and (c) requires that timber harvesting be consistent with (1) restoring and maintaining reference conditions for the region's ecotype (such as with respect to types of trees), (2) restoring and maintaining a representative sample of young, mid, and late successional forest age classes, (3) maintaining or restoring the resources' ecological health for purposes of preventing damage from fire, insect, or disease, (4) maintaining or enhancing wildlife or fish habitat, or (5) enhancing research opportunities in sustainable renewable resource uses.

Recapture taxes

Once the qualified forest conservation bonds issued for a qualified organization are no longer outstanding or cease to qualify as qualified private activity bonds, the qualified organization becomes liable for a recapture of tax benefits (plus interest) for its excess harvesting activities. Under the provision, if the average annual area of timber harvested from the land exceeds the applicable 2.5 percent average annual area limitation, the organization's income tax liability is increased by the amount of the tax benefits (plus interest) attributable to such excess harvesting.

EFFECTIVE DATE

The provision is effective for obligations issued on or after the date that is 180 days after the date of enactment.

[17] This debt service limitation does not apply to income that otherwise is not subject to tax under other provisions of the Code (e.g., income from harvesting if such harvesting activity is not an unrelated trade or business within the meaning of section 513 with respect to the qualified organization).

I. Deduction for Qualified Timber Gain and Timber REIT Provisions

(Secs. 209–214 of the bill and new sec. 1203, and secs. 856, 857 and 4981 of the Code)

PRESENT LAW

Treatment of certain timber gain

Under present law, if a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)). For purposes of determining the gain attributable to such cutting, and the cost of the cut timber for purposes of the taxpayer's income from later sales of the timber or timber products, the fair market value of the timber on the first day of the taxable year in which the timber is used. Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (sec. 631(b)). This treatment under either section 631(a) or (b) requires that the taxpayer has owned the timber or held the contract right for a period of more than one year.

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on long term capital gain ("net capital gain") [18] of an individual, estate, or trust is 15 percent. Any net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a 5-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.[19]

For taxable years beginning after December 31, 2010, the maximum rate of tax on the net capital gain of an individual is 20 percent. Any net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate. In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise have been taxed at a 20-percent rate, is taxed at an 18-percent rate. The net capital gain of a corporation is taxed at the same rates as ordinary income, up to a maximum rate of 35 percent.

Real estate investment trusts ("REITs") are subject to a special taxation regime. Under this regime, a REIT is allowed a deduction for dividends paid to its shareholders.[20] As a result, REITs generally do not pay tax on distributed income, but the income is taxed

[18] Net capital gain is defined as the excess of net long-term capital gain over net short-term capital gain for the taxable year. Sec. 1222(11).

[19] Because the entire amount of the capital gain is included in alternative minimum taxable income ("AMTI"), for taxpayers subject to the alternative minimum tax with AMTI in excess of $112,500 ($150,000 in the case of a joint return), the gain may cause a reduction in the minimum tax exemption amount and thus effectively tax the gain at rates of 21.5 or 22 percent. Also the gain may cause the phase-out of certain benefits in computing the regular tax.

[20] A distribution to a corporate shareholder out of current or accumulated earnings and profits of the corporation is a dividend, unless the distribution is a redemption that terminates the shareholder's stock interest or reduces the shareholder's interest in the distributing corporation to an extent considered to result in treatment as a sale or exchange of the shareholder's stock. Secs. 301 and 302. A distribution in excess of corporate earnings and profits is treated by shareholders as first a recovery of their stock basis and then, to the extent the distribution exceeds a shareholder's stock basis, as a sale or exchange of the stock. Sec. 301. These rules generally apply to REITs.

to the REIT shareholders. A REIT that has long term capital gain can declare a dividend that shareholders are entitled to treat as long term capital gain.

REITs generally are required to distribute 90 percent of their taxable income (other than net capital gain). A REIT generally must pay tax at regular corporate rates on any undistributed income. However, a REIT that has net capital gain can retain that gain without distributing it, and the shareholders can report the net capital gain as if it were distributed to them. In that case the REIT pays a C corporation tax on the retained gain, but the shareholders who report the income are entitled to a credit or refund for the difference between the tax that would be due if the income had been distributed and the 35-percent rate paid by the REIT.[21] In effect, net capital gain of a REIT (including but not limited to timber gain) can be taxed as net capital gain of the shareholders, whether or not the gain is distributed.

Other REIT provisions

A REIT is also subject to a 4-percent excise tax to the extent it does not distribute specified percentages of its income within any calendar year. The required distributed percentage is 85 percent in the case of the REIT ordinary income, and 95 percent in the case of the REIT capital gain net income (as defined).[22] The amount of the excess of the required distribution over the actual distribution is subject to the 4-percent tax.

A REIT generally is restricted to earning certain types of passive income. Among other requirements, at least 75 percent of the gross income of a REIT in a taxable year must consist of certain types of real estate related income, including rents from real property, income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, and interest on mortgages secured by real property or interests in real property.[23] Interests in real property are specifically defined to exclude mineral, oil, or gas royalty interests.[24] A REIT will not qualify as a REIT, and will be taxable as a C corporation, for any taxable year if it does not meet this income test.

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees under section 631(b) can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of

[21] Sec. 857(b)(3)(D). The shareholders also obtain a basis increase in their REIT stock for the gross amount of the deemed distribution that is included in their income less the amount of corporate tax deemed paid by them that was paid by the REIT on the retained gain. Sec. 857(b)(3)(D)(iii).

[22] Section 4981. The definition is the excess of gains from sales or exchanges of capital assets over losses from such sales or exchanges for the calendar year, reduced by any net ordinary loss.

[23] Section 856(c) and section 1221(a). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) is also qualified REIT income.

[24] Section 856(c)(5)(C).

uncut trees can qualify as capital gain derived from the sale of real property.[25]

A REIT is subject to a 100-percent excise tax on gain from any sale that is a “prohibited transaction,” defined as a sale of property that is stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[26] This determination is based on facts and circumstances. However, a safe-harbor provides that no excise tax is imposed if certain requirements are met. In the case of timber property, the safe harbor is met, regardless of the number of sales that occur during the taxable year, if (i) the REIT has held the property for not less than 4 years in connection with the trade or business of producing timber; (ii) the aggregate adjusted bases of the property sold (other than foreclosure property) during the taxable year does not exceed 10 percent of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, and if certain other requirements are met. These include requirements that limit the amount of expenditures the REIT can make during the 4-year period prior to the sale that are includible in the adjusted basis of the property,[27] that require marketing to be done by an independent contractor, and that forbid a sales price that is based on the income or profits of any person.[28] There is a similar but separate safe harbor for sales of non-timber property, with similar rules, including a 4-year holding period requirement and a limit on the percentage of the aggregate adjusted basis of property that can be sold in one taxable year.[29]

A REIT is not generally permitted to hold securities representing more than 10 percent of the voting power or value of the securities of any one issuer; nor may more than 5 percent of the fair market value of REIT assets be securities of any one issuer.[30] However, under an exception, a REIT may hold any amount of securities of one or more “taxable REIT subsidiary” (TRS) corporations, provided that such TRS securities do not represent more than 20 percent of the fair market value of REIT assets at the end of any quarter. A TRS is a C corporation that is subject to regular corporate tax on its income and that meets certain other requirements. A taxable REIT subsidiary may conduct activities that would produce disqualified non-passive or non-real estate income that could disqualify the REIT if conducted by a REIT itself. Such business could include business relating to processing timber, or holding timber products or other assets for sale to customers in the ordinary

[25] Timber income under section 631(b) has also been held to be qualified real estate income even if the one year holding period is not met. See, e.g., PLR 200052021, see also PLR 199945055, PLR 199927021, PLR 8838016. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

[26] Sections 857(b)(6) and 1221(a)(1). There is an exception for certain foreclosure property.

[27] Aggregate expenditures (other than timberland acquisition expenditures) during such period made by the REIT or a partner of the REIT, which are includible in basis, may not exceed 30 percent of the net selling price in the case of expenditures that are directly related to operation of the property for the production of timber or the preservation of the property for use as timberland, and may not exceed 5 percent of the net selling price in the case of expenditures that are not directly related to those purposes.

[28] Section 857(b)(6)(D).

[29] Section 857(b)(6)(C).

[30] Section 856(c)(4)(B)(ii) and (iii). Certain interests are not treated as “securities” for purposes of the rule forbidding the REIT to hold securities representing more than 10 percent of the value of securities of any one issuer. Sec. 856(m).

course of business. Such income would be subject to regular corporate rates of tax as income of the TRS.[31]

REASONS FOR CHANGE

The committee believes it is desirable to provide greater equivalence to the capital gain tax treatment of timber gain, regardless of whether the gain is recognized by a C corporation or a REIT, or by an individual. The committee also believes it is desirable to provide changes to the statutory rules governing REITs, in order to clarify and facilitate timber REIT operations.

EXPLANATION OF PROVISION

Elective deduction for 60 percent of qualified timber gain

The provision allows a taxpayer to elect to deduct an amount equal to 60 percent of the taxpayer's qualified timber gain (or, if less, the net capital gain) for a taxable year. In the case of an individual, the deduction reduces adjusted gross income. Qualified timber gain means the net gain described in section 631(a) and (b) for the taxable year.

The deduction is allowed in computing the regular tax and the alternative minimum tax (including the adjusted current earnings of a corporation).

If a taxpayer elects the deduction, the 40 percent of the gain subject to tax is taxed at ordinary income tax rates.[32]

In the case of a pass-thru entity other than a REIT, the election may be made separately by each taxpayer subject to tax on the gain. The Treasury Department may prescribe rules appropriate to apply this provision to gain taken into account by a pass-thru entity.

In the case of a REIT, the election to take the 60-percent deduction is made by the REIT. If a REIT makes the election, then the timber gain is excluded from the computation of capital gain or loss of the REIT and can no longer be designated as a capital gain dividend to shareholders. Instead, the gain is treated as ordinary income for purposes of applying the REIT income distribution requirements, but for this purpose 60-percent of the amount of the gain is deductible by the REIT in computing its income. REIT earnings and profits also exclude the portion of the timber gain that is deductible. Thus, 40 percent of the gain is subject to the REIT distribution requirements,[33] and 40 percent of the gain increases REIT earnings and profits. Accordingly, because REIT earnings and profits have been increased by the 40-percent amount, there is sufficient earnings and profits that a distribution of that 40-percent amount that otherwise qualifies as a dividend would be treated as an ordinary dividend distribution to shareholders. Since this dividend is from a REIT and is not derived from an entity that was taxed as a C corporation, it would not qualify for the current 15

[31] A 100-percent excise tax is imposed on the amount of certain transactions involving a TRS and a REIT, to the extent such amount would exceed an arm's length amount under section 482. Sec. 857(b)(7).

[32] Under the provision, because only 40 percent of the gain is included in adjusted gross income and AMTI, only that amount of gain would result in the phase-out of tax benefits.

[33] For purposes of the section 4981 excise tax on undistributed REIT income, the amount treated as subject to the 95 percent distribution requirement is the 40 percent of timber gain income that remains after allowing the deduction.

percent qualified dividend rates and would be taxed at the ordinary income rates of the shareholders.

REIT shareholders obtain an upward basis adjustment in their REIT interests, equal to the 60 percent of the timber gain that is deductible by the electing REIT. Because the 60 percent of timber gain that was deductible by the REIT does not increase REIT earnings and profits, a distribution of such 60 percent to the shareholder generally will not be treated as a dividend (in the absence of other retained earnings) but as a return of basis under the general rules of section 301(c). Because the shareholders' basis has been increased by this 60 percent, this distribution would not exceed the shareholders' basis and thus would be nontaxable return of basis, rather than capital gain in excess of basis. However, if a REIT shareholder has obtained such an upward basis adjustment for a REIT interest and disposes of the interest before having held the interest for at least 6 months, then any loss on disposition of the interest is disallowed to the extent of such upward basis adjustment.

Additional REIT provisions

Timber gain qualified REIT income without regard to 1 year holding period

The provision specifically includes timber gain under section 631(a) as a category of statutorily recognized qualified real estate income of a REIT if the cutting is provided by a taxable REIT subsidiary, and also includes gain recognized under section 631(b). For purposes of such qualified income treatment under those provisions, the requirement of a one-year holding period is removed. Thus, for a example, a REIT can acquire timber property and harvest the timber on the property within one year of the acquisition, with the resulting income being qualified real estate income for REIT qualification purposes, even though such income is not eligible for long term capital gain treatment under sections 631(a) or (b). The provision specifically provides, however, that for all purposes of the Code, such income shall not be considered to be gain described in section 1221(a)(1), that is, it shall not be treated as income from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REITs trade or business.

For purposes of determining REIT income, if the cutting is done by a taxable REIT subsidiary, the cut timber is deemed sold on the first day of the taxable year to the taxable REIT subsidiary (with subsequent gain, if any, attributable to the taxable REIT subsidiary).

REIT prohibited transaction safe harbor for timber property

For sales to a qualified organization for conservation purposes, as defined in section 170(h), the provision reduces to 2 years the present law 4-year holding period requirement under section 857(b)(6)(D), which provides a safe harbor from "prohibited transaction" treatment for certain timber property sales. Also, in the case of such sales, the safe-harbor limitations on how much may be added, within the 4-year period prior to the date of sale, to the aggregate adjusted basis of the property, are changed to refer to the 2-year period prior to the date of sale.

The provision also removes the safe-harbor requirement that marketing of the property must be done by an independent contractor, and permits a taxable REIT subsidiary of the REIT to perform the marketing.

The provision states that any gain that is eligible for the timber property safe harbor is considered for all purposes of the Code not to be described in section 1221(a)(1), that is, it shall not be treated as income from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REITs trade or business.

Special rules for Timber REITs

The provision contains several provisions applicable only to a "timber REIT," defined as a REIT in which more than 50 percent of the value of its total assets consists of real property held in connection with the trade or business of producing timber.

First, mineral royalty income from real property owned by a timber REIT and held, or once held, in connection with the trade or business of producing timber by such REIT, is included as qualifying real estate income for purposes of the REIT income tests.

Second, a timber REIT is permitted to hold TRS securities with a value up to 25 percent, (rather than 20 percent) of the value of the total assets of the REIT.

EFFECTIVE DATE

The provision applies to taxable years beginning after the date of enactment, but does not apply after the last day of the first taxable year beginning after the date of enactment.

TITLE III—ENERGY PROVISIONS

A. CREDIT FOR RESIDENTIAL AND BUSINESS WIND PROPERTY

(Sec. 301 of the bill and secs. 25D and 48 of the Code)

PRESENT LAW

Credit for residential energy efficient property

A personal tax credit is allowed for the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs.[34] The credit is equal to 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of $2,000 per taxable year. A 30 percent credit is also allowed for the purchase of qualified fuel cell power plants. The credit for any fuel cell power plant may not exceed $500 for each 0.5 kilowatt of capacity.

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

[34] Sec. 25D.

to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

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

Certain equipment safety requirements must be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

The credit applies to expenditures after December 31, 2005, for property placed in service prior to January 1, 2009.

Energy credit for businesses

In general

A nonrefundable, 10-percent business energy credit[35] is allowed for the cost of new property that is equipment that either (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

The energy credit is a component of the general business credit[36] and as such is subject to the alternative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years.[37] The taxpayer's basis in the property is reduced by one-half of the amount of the credit claimed.[38] For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. Similarly, the credit only applies to expenditures made after the effective date of the provision.

In general, property that is public utility property is not eligible for the credit. Public utility property is property that is used predominantly in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, domestic telegraph services, or other communication services (other than international telegraph services), if the rates for such furnishing or

[35] Sec. 48.
[36] Sec. 38(b)(1).
[37] Sec. 39.
[38] Sec. 50(c)(3).

sale have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission. This rule is waived in the case of telecommunication companies' purchases of fuel cell and microturbine property.

Special rules for solar energy property

The credit for solar energy property is increased to 30 percent in the case of periods after December 31, 2005 and prior to January 1, 2009. Additionally, equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit.

Fuel cells and microturbines

The business energy credit also applies for the purchase of qualified fuel cell power plants, but only for periods after December 31, 2005 and prior to January 1, 2009. The credit rate is 30 percent.

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

The business energy credit also applies for the purchase of qualifying stationary microturbine power plants, but only for periods after December 31, 2005 and prior to January 1, 2009. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

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

Additionally, for purposes of the fuel cell and microturbine credits, and only in the case of telecommunications companies, the general present-law section 48 restriction that would otherwise prohibit telecommunication companies from claiming the new credit due to their status as public utilities is waived.

REASONS FOR CHANGE

The Committee believes that the promotion of viable alternative energy sources is essential to reduce dependence of foreign oil and to reduce the harmful impacts of fossil fuel consumption. As wind energy is a proven and effective alternative means of electricity generation, the Committee believes a credit for wind energy property should be made available on similar terms to that provided for solar electric generation under present law.

EXPLANATION OF PROVISION

Residential wind credit

The provision provides a 30 percent credit for qualified small wind energy property expenditures made by the taxpayer during the taxable year. The credit is limited to $4,000 per taxable year. Qualified small wind energy property expenditures are expenditures for property that uses a qualified wind turbine to generate electricity for use in a dwelling unit located in the U.S. and used as a residence by the taxpayer. A qualifying wind turbine means a wind turbine of 100 kilowatts of rated capacity or less that meets the latest performance rating standards published by the American Wind Energy Association.

Business wind credit

The provision provides a credit of 30 percent of the basis of qualified small wind energy property placed in service during the taxable year. The credit is limited to $4,000 per taxable year. Qualified small wind energy property is property that uses a qualified wind turbine to generate electricity for use in the U.S. A qualifying wind turbine means a wind turbine of 100 kilowatts of rated capacity or less that meets the latest performance rating standards published by the American Wind Energy Association. As part of the section 48 energy credit, a basis reduction of 50 percent of the amount of the credit applies.

EFFECTIVE DATE

The provision is effective for expenditures after December 31, 2007, for property placed in service prior to January 1, 2009.

B. LANDOWNER INCENTIVE TO ENCOURAGE ELECTRIC TRANSMISSION BUILD-OUT

(Sec. 302 of the bill and new sec. 139B of the Code)

PRESENT LAW

Gross income includes all income from whatever source derived unless a specific exclusion applies.[39]

REASON FOR CHANGE

The Committee believes that an incentive should be provided for the build-out of electricity generated from certain alternative energy sources.

EXPLANATION OF PROVISION

The proposal provides an exclusion from gross income for any qualified electric transmission easement payment. For purposes of the proposal, a qualified electric transmission easement payment is any payment by an electric utility or electric transmission entity pursuant to an easement or other agreement granted by the payee for the right to locate on the payee's property transmission lines and equipment used to transmit electricity at 230 or more kilovolts

[39] Sec. 61.

primarily from qualified facilities described in section 45(d) (without regard to any placed in service date).

EFFECTIVE DATE

The proposal is effective for payments received after the date of enactment.

C. Exception to Reduction of Renewable Electricity Credit

(Sec. 303 of the bill and sec. 45 of the Code)

PRESENT LAW

In general

An income tax credit is allowed for the production of electricity at qualified facilities using qualified energy resources.[40] Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. In addition to the electricity production credit, an income tax credit is allowed for the production of refined coal and Indian coal at qualified facilities.[41]

Credit amounts and credit period

In general

The base amount of the electricity production credit is 1.5 cents per kilowatt-hour (indexed annually for inflation) of electricity produced. The amount of the credit is 2 cents per kilowatt-hour for 2007. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The amount of credit a taxpayer may claim is phased out as the market price of electricity (or refined coal in the case of the refined coal production credit) exceeds certain threshold levels. The electricity production credit is reduced over a 3 cent phase-out range to the extent the annual average contract price per kilowatt hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation). The refined coal credit is reduced over an $8.75 phase-out range as the reference price of the fuel used as feedstock for the refined coal exceeds the reference price for such fuel in 2002 (adjusted for inflation).

Reduced credit amounts and credit periods

Generally, in the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the 10-year

[40] Sec. 45.

[41] Collectively, the electricity production credit, the refined coal production credit, and the Indian coal production credit are referred to herein as the section 45 credit.

credit period is reduced to five years commencing on the date the facility was originally placed in service, for qualified facilities placed in service before August 8, 2005. However, for qualified open-loop biomass facilities (other than a facility described in sec. 45(d)(3)(A)(i) that uses agricultural livestock waste nutrients) placed in service before October 22, 2004, the five-year period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (currently 1 cent per kilowatt-hour for 2007).

Credit applicable to refined coal

The amount of the credit for refined coal is $4.375 per ton (also indexed for inflation after 1992 and equaling $5.877 per ton for 2007).

Credit applicable to Indian coal

A credit is available for the sale of Indian coal to an unrelated third part from a qualified facility for a seven-year period beginning on January 1, 2006, and before January 1, 2013. The amount of the credit for Indian coal is $1.50 per ton for the first four years of the seven-year period and $2.00 per ton for the last three years of the seven-year period. Beginning in calendar years after 2006, the credit amounts are indexed annually for inflation using 2005 as the base year; for 2007 the Indian coal credit is $1.544 per ton.

Special rules and other limitations on credit claimants and credit amounts

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

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

The credit for electricity produced from renewable sources is a component of the general business credit.[42] For alternative minimum tax purposes, a taxpayer's tentative minimum tax is treated as being zero when determining the tax liability limitation for the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

Special rules apply for eligible cooperatives claiming the section 45 credit. For taxable years ending after August 8, 2005, eligible cooperatives may elect to pass any portion of the credit through to their patrons. An eligible cooperative is defined as a cooperative organization that is owned more than 50 percent by agricultural producers or entities owned by agricultural producers. The credit may be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year.

Qualified facilities

Wind energy facility

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2009.

Closed-loop biomass facility

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

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2009. In the case of a facility using closed-loop biomass but also cofiring the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2009.

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

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

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;

[42] Sec. 38(b)(8).

- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimming; or
- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure. Wood waste materials do not qualify as open-loop biomass to the extent they are pressure treated, chemically treated, or painted. In addition, municipal solid waste, gas derived from the biodegradation of solid waste, and paper which is commonly recycled do not qualify as open-loop biomass. Open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2009, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2009.

Geothermal facility

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit that is a geothermal reservoir consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after October 22, 2004 and before January 1, 2009.

Solar facility

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

Small irrigation facility

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility must be at least 150 kilowatts but less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after October 22, 2004, and before January 1, 2009.

Landfill gas facility

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004, and before January 1, 2009.

Trash combustion facility

Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004 and before January 1, 2009. A qualified trash combustion facility includes a new unit, placed in service after October 22, 2004, that increases electricity production capacity at an existing trash combustion facility. A new unit generally would include a new burner/boiler and turbine. The new unit may share certain common equipment, such as trash handling equipment, with other pre-existing units at the same facility. Electricity produced at a new unit of an existing facility qualifies for the production credit only to the extent of the increased amount of electricity produced at the entire facility.

Hydropower facility

A qualifying hydropower facility is (1) a facility that produced hydroelectric power (a hydroelectric dam) prior to August 8, 2005, at which efficiency improvements or additions to capacity have been made after such date and before January 1, 2009, that enable the taxpayer to produce incremental hydropower or (2) a facility placed in service before August 8, 2005, that did not produce hydroelectric power (a nonhydroelectric dam) on such date, and to which turbines or other electricity generating equipment have been added after such date and before January 1, 2009.

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

At a nonhydroelectric dam, the facility must be licensed by the Federal Energy Regulatory Commission and meet all other applicable environmental, licensing, and regulatory requirements and the turbines or other generating devices must be added to the facility after August 8, 2005 and before January 1, 2009. In addition there must not be any enlargement of the diversion structure, or construction or enlargement of a bypass channel, or the impoundment or any withholding of additional water from the natural stream channel.

Refined coal facility

A qualifying refined coal facility is a facility producing refined coal that is placed in service after October 22, 2004 and before January 1, 2009. Refined coal is a qualifying liquid, gaseous, or solid fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxides and either SO_2 or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal the fuel must be sold by the taxpayer with the reasonable expectation that it will be used for the primary purpose of producing steam.

Indian coal facility

A qualified Indian coal facility is a facility which is placed in service before January 1, 2009, that produces coal from reserves that on June 14, 2005, were owned by a Federally recognized tribe of Indians or were held in trust by the United States for a tribe or its members.

Summary of credit rate and credit period by facility type

TABLE 1.—SUMMARY OF SECTION 45 CREDIT

Eligible electricity production or coal production activity	Credit amount for 2007 (cents per kilowatt-hour; dollars per ton)	Credit period for facilities placed in service on or before August 8, 2005 (years from placed-in-service date)	Credit period facilities placed in service after August 8, 2005 (years from placed-in-service date)
Wind	2	10	10
Closed-loop biomass	2	[1] 10	10
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1	[2] 5	10
Geothermal	2	5	10
Solar (pre-2006 facilities only)	2	5	10
Small irrigation power	1	5	10
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1	5	10
Qualified hydropower	1	N/A	10
Refined Coal	5.877	10	10
Indian Coal	1.544	[3] 7	[3] 7

[1] In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.
[2] For certain facilities placed in service before October 22, 2004, the 5-year credit period commences on January 1, 2005.
[3] For Indian coal, the credit period begins for coal sold after January 1, 2006.

REASONS FOR CHANGE

The Committee believes that building additional renewable energy infrastructure advances America's environmental and energy independence goals. The Committee believes that additional renewable energy infrastructure will be built if the tax incentives for renewable energy are better coordinated with certain federal spending programs.

EXPLANATION OF PROVISION

The provision provides an exception to the reduction in the section 45 credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits. Under the provision, the section 45 credit is not reduced by any loans, loan guarantees, or grants to farmers, ranchers, or rural small businesses issued by the Secretary of Agriculture under authority granted by section 9006 of the Farm Security and Rural Investment Act of 2002 (Pub. L. No. 107–171).

EFFECTIVE DATE

The provision is effective for facilities placed in service after the date of enactment.

D. Expansion of Special Depreciation Allowance to Cellulosic Biomass Alcohol Fuel Plant

(Sec. 311 of the bill and sec. 168(l) of the Code)

PRESENT LAW

Section 168(l) allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified cellulosic biomass ethanol plant property. In order to qualify, the property generally must be placed in service before January 1, 2013.

Qualified cellulosic biomass ethanol plant property means property used in the U.S. solely to produce cellulosic biomass ethanol. For this purpose, cellulosic biomass ethanol means ethanol derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. For example, lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis includes bagasse (from sugar cane), corn stalks, and switchgrass.

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following requirements. The original use of the property must commence with the taxpayer on or after December 20, 2006. The property must be acquired by purchase (as defined under section 179(d)) by the taxpayer after December 20, 2006, and placed in service before January 1, 2013. Property does not qualify if a binding written contract for the acquisition of such property was in effect on or before December 20, 2006.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after December 20, 2006, and the property is placed in service before January 1, 2013 (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Property any portion of which is financed with the proceeds of a tax-exempt obligation under section 103 is not eligible for the additional first-year depreciation deduction. Recapture rules apply if the property ceases to be qualified cellulosic biomass ethanol plant property.

Property with respect to which the taxpayer has elected 50 percent expensing under section 179C is not eligible for the additional first-year depreciation deduction.

REASONS FOR CHANGE

The Committee believes that the expensing provision should include any cellulosic biomass alcohol and not be limited to ethanol. Additionally, the Committee believes that the provision should not be limited to certain processes.

EXPLANATION OF PROVISION

The provision changes the definition of qualified property. Under the provision, qualified property includes property used solely to produce cellulosic biomass alcohol. Cellulosic biomass alcohol is defined as any alcohol produced by any process from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis.

EFFECTIVE DATE

The provision is effective for property placed in service in taxable years ending after the date of enactment.

E. CREDIT FOR PRODUCTION OF CELLULOSIC BIOMASS ALCOHOL

(Sec. 312 of the bill and sec. 40 of the Code)

PRESENT LAW

In the case of ethanol, the Code provides a separate 10-cents-per-gallon credit for up to 15 million gallons per year for small producers, defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons. The credit is includible in income and is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The alcohol fuels tax credit, of which the small producer credit is a part, is scheduled to expire after December 31, 2010.

Under the Renewable Fuels Standard Program all renewable fuel produced or imported on or after September 1, 2007 must have a renewable identification number (RIN) associated with it. Producers and importers must generate RINs to represent all the renewable fuel they produce or import and provide those RINs to the

EPA. For cellulosic ethanol, 2.5 RINs are generated for every gallon produced.

REASONS FOR CHANGE

The Committee believes that the development of fuels from cellulosic materials, such as corn stover, switchgrass, and other organic materials that can be grown anywhere, is a significant component in establishing the nation's energy independence. Tax incentives are an important part of taking this industry from the level of demonstration projects into a practical and competitive fuel source. To encourage new production capacity for this fuel, the provision provides a new per-gallon incentive for cellulosic alcohol fuel producers.

EXPLANATION OF PROVISION

The provision provides an income tax credit for up to 60 million gallons of qualified cellulosic fuel production of the producer for the taxable year. The amount of the credit per gallon is $1.28 less the credit amount for alcohol fuel and the credit amount for small ethanol producers as of the date the cellulosic alcohol fuel is produced. This credit is in addition to any credit that may be available under section 40 of the Code. A small cellulosic alcohol fuel producer is not precluded from also claiming the alcohol or alcohol fuel mixture credit, or the small ethanol producer credit, if the requirements for those credits are also met. For example, in the case of a gallon of ethanol, a small producer may be able to claim 50 cents as a cellulosic alcohol producer, plus 51 cents under the alcohol fuel mixture credit, and an additional 10 cents as a small ethanol producer.

Qualified cellulosic fuel production is any cellulosic alcohol which is produced by a small cellulosic alcohol fuel producer during the taxable year which is sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such alcohol at retail to another person and places such alcohol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

Cellulosic alcohol is alcohol that is produced in the United States and is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. Examples of lignocellulosic or hemicellulosic matter that is available of a renewable or recurring basis includes dedicated energy crops and trees, wood and wood residues, plants, grasses, agricultural residues, fibers, animal wastes and other waste materials, and municipal solid waste.

Generally, a small cellulosic alcohol fuel producer is a cellulosic alcohol producer whose production capacity does not exceed 60 million gallons.

The small cellulosic alcohol producer credit is limited to domestic production. Only domestically produced cellulosic alcohol sold for use, or used, in the United States qualifies for the credit.

The small cellulosic alcohol producer credit terminates on April 1, 2015.

EFFECTIVE DATE

The provision is effective for alcohol produced after December 31, 2007.

F. Extension of Small Ethanol Producer Credit

(Sec. 313 of the bill and sec. 40 of the Code)

PRESENT LAW

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2010.[43]

Taxpayers are eligible for an income tax credit of 51 cents per gallon of ethanol (60 cents in the case of alcohol other than ethanol) used in the production of a qualified mixture (the "alcohol mixture credit"). A "qualified mixture" means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The term "alcohol" includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150.

Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). For alcohol other than ethanol, the rate is 60 cents per gallon.[44]

In the case of ethanol, the Code provides an additional 10-cents-per-gallon credit for up to 15 million gallons per year for small producers. Small producers are defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) be used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons.

The alcohol fuels credit is includible in income and is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The credit is allowable against the alternative minimum tax.

REASONS FOR CHANGE

The Committee believes that as the ethanol industry continues to mature, it is appropriate to encourage small producers to con-

[43] The alcohol fuels credit is unavailable when, for any period before January 1, 2011, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

[44] In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 37.78 cents.

tinue to participate in such industry. Therefore, the bill extends the small ethanol producer credit for an additional two years.

EXPLANATION OF PROVISION

The provision extends the small ethanol producer component of the alcohol fuels credit for an additional two years (through December 31, 2012).

EFFECTIVE DATE

The provision is effective on the date of enactment.

G. CREDIT FOR PRODUCERS OF FOSSIL-FREE ALCOHOL

(Sec. 314 of the bill and sec. 40 of the Code)

PRESENT LAW

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2010.[45]

Taxpayers are eligible for an income tax credit of 51 cents per gallon of ethanol (60 cents in the case of alcohol other than ethanol) used in the production of a qualified mixture (the "alcohol mixture credit"). A "qualified mixture" means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The term "alcohol" includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150.

Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). For alcohol other than ethanol, the rate is 60 cents per gallon.[46]

In the case of ethanol, the Code provides an additional 10-cents-per-gallon credit for up to 15 million gallons per year for small producers. Small producer is defined generally as a producer whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) be used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons.

The alcohol fuels credit is includible in income and is treated as a general business credit, subject to the ordering rules and

[45] The alcohol fuels credit is unavailable when, for any period before January 1, 2011, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

[46] In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 37.78 cents.

carryforward/carryback rules that apply to business credits generally. The credit is allowable against the alternative minimum tax.

REASONS FOR CHANGE

The production of ethanol consumes a significant amount of fossil fuel. To encourage the use of alternative fuels in that production process, the Committee believes it is appropriate to provide an additional credit to small producers of ethanol that displace 90 percent of the fossil-fuel use with bio-based fuels.

EXPLANATION OF PROVISION

The provision adds a new component to the alcohol fuels credit, the small fossil-free alcohol producer credit. The credit provides an additional 25-cents-per-gallon credit for up to 60 million gallons of alcohol produced at a fossil-free facility during the calendar year for small producers. Small producer is defined generally as a producer whose fossil-free alcohol production capacity does not exceed 60 million gallons per year. A fossil-free facility is one at which 90 percent of the fuel used in the production of alcohol at such facility is from biomass as defined in sec. 45K(c)(3).

The alcohol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c). Only domestically produced alcohol, sold for use or used in the United States qualifies for the credit. A cooperative may pass through the small producer credit to its patrons.

The credit terminates after December 31, 2012.

EFFECTIVE DATE

The provision is effective after December 31, 2007.

H. MODIFICATION OF ALCOHOL CREDIT

(Sec. 315 of the bill and secs. 40, 6426 and 6427 of the Code)

Income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2010.[47]

Taxpayers are eligible for an income tax credit of 51 cents per gallon of ethanol (60 cents in the case of alcohol other than ethanol) used in the production of a qualified mixture (the "alcohol mixture credit"). A "qualified mixture" means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The term "alcohol" includes methanol and ethanol but does not in-

[47] The alcohol fuels credit is unavailable when, for any period before January 1, 2011, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

clude (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150.

Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). For alcohol other than ethanol, the rate is 60 cents per gallon.[48]

In the case of ethanol, the Code provides an additional 10-cents-per-gallon credit for up to 15 million gallons per year for small producers. Small producer is defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons.

The alcohol fuels credit is includible in income and is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The credit is allowable against the alternative minimum tax.

Excise tax credit and payment provision for alcohol fuel mixtures

The Code also provides an excise tax credit and payment provision for alcohol fuel mixtures. Like the income tax credit, the amount of the credit is 60 cents per gallon of alcohol used as part of a qualified mixture (51 cents in the case of ethanol). For purposes of the excise tax credit and payment provisions, alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 190. Such term also includes an alcohol gallon equivalent of ethyl tertiary butyl either or other ethers produced from alcohol. In lieu of a tax credit, a person making a qualified mixture eligible for the credit may seek a payment from the Secretary in the amount of the credit. The payment provisions and credits are coordinated such that the incentive is not claimed more than once for each gallon of alcohol used as part of qualified mixture.

Renewable Fuels Standard Program

Under the Renewable Fuels Standard Program all renewable fuel produced or imported on or after September 1, 2007 must have a renewable identification number (RIN) associated with it. Producers and importers must generate RINs to represent all the renewable fuel they produce or import and provide those RINs to the Environmental Protection Agency. For cellulosic ethanol, 2.5 RINs are generated for every gallon produced.

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[48] In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 37.78 cents.

REASONS FOR CHANGE

As the ethanol industry further matures, the Committee believes it is appropriate to reduce the amount of the tax incentive.

EXPLANATION OF PROVISION

Under the provision, the 51-cent-per-gallon incentive for ethanol is adjusted to 46 cents per gallon beginning with the first calendar year after the year in which the Environmental Protection Agency receives RINs in an amount equivalent to 7.5 billion gallons of ethanol (including cellulosic ethanol).

EFFECTIVE DATE

The provision is effective on the date of enactment.

I. CALCULATION OF VOLUME OF ALCOHOL FOR FUELS CREDITS

(Sec. 316 of the bill, and sec. 40 of the Code)

PRESENT LAW

The Code provides a per-gallon credit for the volume of alcohol used as a fuel or in a qualified mixture. For purposes of determining the number of gallons of alcohol with respect to which the credit is allowable, the volume of alcohol includes any denaturant, including gasoline.[49] The denaturant must be added under a formula approved by the Secretary and the denaturant cannot exceed five percent of the volume of such alcohol (including denaturants).

REASONS FOR CHANGE

Gasoline can be used as a denaturant of alcohol. The Committee believes it is inappropriate to allow a credit that is intended to be for alcohol to be claimed on liquids that do not constitute alcohol.

EXPLANATION OF PROVISION

The provision provides that the volume of alcohol eligible for the credit does not include the volume of any denaturant.

EFFECTIVE DATE

The provision is effective January 1, 2008.

J. ETHANOL TARIFF EXTENSION

(Sec. 317 of the bill)

PRESENT LAW

Heading 9901.00.50 of the Harmonized Tariff Schedule of the United States imposes a cumulative general duty of 14.27 cents per liter (approximately 54 cents per gallon) to imports of ethyl alcohol, and any mixture containing ethyl alcohol, if used as a fuel or in producing a mixture to be used as a fuel, that are entered into the United States prior to January 1, 2009. The temporary duty under heading 9901.00.50 offsets the alcohol fuels credit of 51 cents per gallon that is available to taxpayers that blend ethanol with gaso-

[49] Sec. 40(d)(4).

line; both domestic and imported ethanol is eligible for the alcohol fuels credit.

Heading 9901.00.52 of the Harmonized Tariff Schedule of the United States imposes a general duty of 5.99 cents per liter to imports of ethyl tertiary-butyl ether, and any mixture containing ethyl tertiary-butyl ether, that are entered into the United States prior to January 1, 2009.

REASONS FOR CHANGE

The Committee believes it is appropriate to extend the tariff through the end of calendar year 2010.

EXPLANATION OF PROVISION

The provision modifies the existing effective period for ethyl alcohol as classified under heading 9901.00.50 and 9901.00.52 of the Harmonized Tariff Schedule of the United States from before January 1, 2009 to before January 1, 2011.

EFFECTIVE DATE

The provision is effective on the date of enactment.

K. Elimination and Reductions of Duty Drawback on Certain Imported Ethanol

(Sec. 318 of the bill)

PRESENT LAW

Subheading 9901.00.50, Harmonized Tariff Schedule of the United States ("HTSUS"), imposes an additional duty on ethanol that is used as fuel or use to make fuel. Subsection (b) of Section 1313 of the Tariff Act of 1930, as amended, permits the refund of duty if the duty-paid good, or a substitute good, is used to make an article that is exported. Subsection (j)(2) of Section 1313 permits the refund of duty if the duty-paid good, or a substitute good, is exported. Subsection (p) of section 1313 permits the substitution on exportation for drawback eligibility of one motor fuel for another motor fuel. A person who manufactures or acquires gasoline with ethanol subject to the duty imposed by subheading 9901.00.50, HTSUS, can export jet fuel (which does not involve the use of ethanol) and obtain a refund of the duty paid under subheading 9901.00.50, HTSUS.

REASONS FOR CHANGE

The Committee believes it is appropriate to eliminate the ability to claim duty drawback on the substitution of jet fuel for ethyl alcohol (ethanol), or an ethyl alcohol mixture, used as a fuel. In addition, the Committee believes that it is appropriate to eliminate the ability to claim duty drawback on the substitution of a low-value ethyl alcohol for ethyl alcohol (ethanol) subject to the duty under HTSUS subheading 9901.00.50.

EXPLANATION OF PROVISION

The provision eliminates the ability to obtain a refund of the duty imposed by subheading 9901.00.50, HTSUS by substitution of ethanol not subject to the duty under subheading 9901.00.50, HTSUS for ethanol subject to the duty imposed under subheading 9901.00.50, HTSUS, for drawback purposes. The provision also prevents a petroleum product which contains ethanol from being substituted for any other petroleum product that is exported to obtain drawback.

EFFECTIVE DATE

The provision is effective for any good exported on and after the fifteenth day after enactment.

L. EXTENSION OF CREDITS FOR BIODIESEL

(Sec. 321 of the bill and secs. 40A, 6426 and 6427 of the Code)

PRESENT LAW

Income tax credit

Overview

The Code provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[50] The biodiesel fuels credit is the sum of the biodiesel mixture credit, the biodiesel credit, and the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2008.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats. The language "including" indicates that this list is not exclusive.[51] Camelina is a plant from which oil can be extracted.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel which identifies the product produced and the percentage of the biodiesel and agri-biodiesel in the product.

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel (other than agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is $1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into

[50] Sec. 40A.
[51] Treasury Notice 2005–62.

account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

The biodiesel credit is 50 cents for each gallon of biodiesel which is not in a mixture with diesel fuel (100 percent biodiesel or B–100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle. For agri-biodiesel, the credit is $1.00 per gallon.

Small agri-biodiesel producer credit

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.[52] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is $1.00 per gallon. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[53]

The credit is not available for any sale or use for any period after December 31, 2008. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[54] To the extent the biodiesel fuel mixture credit exceeds the section 4081 liability of a person, the Secretary is to pay such person an amount equal to the bio-

[52] Sec. 6426(c).
[53] Sec. 6426(c)(4).
[54] Sec. 6427(e).

diesel fuel mixture credit with respect to such mixture.[55] Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2008.

REASONS FOR CHANGE

The Committee believes it is appropriate to extend the biodiesel incentives to further encourage the development and use of this fuel. In particular, to encourage the participation of small producers into the market, the Committee believes it is appropriate to extend the small agri-biodiesel producer credit an additional four years.

EXPLANATION OF PROVISION

The provision generally extends an additional two years (through December 31, 2010) the income tax credit, excise tax credit, and payment provisions for biodiesel (including agri-biodiesel). The small agri-biodiesel producer credit is extended an additional four years (through December 31, 2012). The provision adds camelina to the illustrative and nonexclusive list of sources of virgin oils for agri-biodiesel.

EFFECTIVE DATE

The provision is effective on the date of enactment.

M. Extension and Modification of Renewable Diesel Incentives

(Sec. 321 of the bill and sec. 40A(f), 6426 and 6427 of the Code)

PRESENT LAW

The Code provides a tax incentive of $1.00 per gallon relating to renewable diesel that is part of a qualified mixture with diesel fuel. This incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[56] The incentive is available only to the person who produced and sold or used the mixture in their trade or business and is based on the gallons of renewable diesel in the mixture. The provisions relating to renewable diesel do not apply after December 31, 2008.

"Renewable diesel" is diesel fuel that (1) is derived from biomass (as defined in section 45K(c)(3)[57]) using a thermal depolymerization process; (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under section 211 of the Clean Air Act (42 U.S.C. sec. 7545); and (3) meets the requirements of the American Society of Testing and Materials (ASTM) D975 or D396. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines.

[55] Sec. 6427(e)(1) and 6427(e)(3).

[56] Secs. 40A, 6426(c), and 6427(e). For purposes of the Code, renewable diesel is generally treated as biodiesel. The Code also provides an income tax credit for renewable diesel that is not in a mixture which is sold at retail to a person and placed in the fuel tank of such person's vehicle or used by the taxpayer producing the renewable diesel as a fuel in a trade or business. See sec. 40A(b)(2) in conjunction with sec. 40A(f)(1).

[57] "Biomass" means any organic material other than (1) oil and natural gas (or any product thereof) and (2) coal (including lignite) or any product thereof (sec. 45K(c)(3)).

ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces.

Pursuant to IRS Notice 2007–37, the Secretary provided that fuel produced as a result of co-processing biomass and petroleum feedstock ("co-produced fuel") qualifies for the renewable diesel incentives to the extent of the fuel attributable to the biomass in the mixture. In co-produced fuel, the fuel attributable to the biomass does not exist as a distinct separate quantity prior to mixing.

REASONS FOR CHANGE

To encourage the further development of renewable diesel, the Committee believes it is appropriate to extend the tax incentives for this fuel. However, the Committee also believes that less incentives are needed for renewable diesel produced as part of the refining process of crude oil. Utilizing existing refinery processes does not require significant investment in new equipment to produce the renewable diesel. Therefore, the Committee limits the incentive as it relates to co-produced fuel.

EXPLANATION OF PROVISION

The provision provides that, on a per year basis, producers of co-produced fuel may claim $1.00 per gallon for up to 60 million gallons of renewable diesel contained in a qualified mixture. The 60 million gallons is determined on a per facility basis. No credit is allowable for gallons in excess of 60 million gallons produced at a facility. As under present law, the credit and payments are only for that volume of renewable diesel contained in the qualified mixture and not the total volume of co-produced fuel.

The provision extends the tax incentives for renewable diesel (income tax credit, excise tax credit, and payment provisions) an additional two years (through December 31, 2010).

EFFECTIVE DATE

The provision restricting the amount of credit allowable for co-produced fuels is effective for fuels sold or used after the date of enactment. The extension of the renewable diesel incentives is effective on the date of enactment.

N. TREATMENT OF QUALIFIED ALCOHOL MIXTURES AND QUALIFIED BIODIESEL FUEL MIXTURES AS TAXABLE FUELS

(Sec. 322 of the bill and sec. 4083 of the Code)

PRESENT LAW

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[58] The tax does not apply to any removal or entry of taxable fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel (excluding deep draft vessels) and the operator of such ter-

[58] Sec. 4081(a)(1).

minal or refinery are registered with the Secretary.[59] The term "taxable fuel" means gasoline, diesel fuel, and kerosene.[60]

Diesel fuel is (1) any liquid suitable for use in a diesel powered highway vehicle or diesel powered train, (2) transmix, and (3) diesel fuel blendstocks identified by the Secretary.[61] By regulation, diesel fuel does not include kerosene, gasoline, No. 5 and No. 6 fuel oils (as described in ASTM Specification D 396), or F–76 (Fuel Naval Distillates MIL–F–16884) any liquid that contains less than four percent normal parafins, or any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur content of 10 ppm or less and minimum color of +27 Saybolt.[62]

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter which meet (1) the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under section 211 of the Clean Air Act, and (2) the requirements of the American Society of Testing Materials D6751 ("ASTM D6751").

Biodiesel is not a taxable fuel because it has less than four percent paraffin content. Ethanol and other fuel alcohols also are not treated as taxable fuel. However, such fuels are subject to the backup tax under section 4041 if sold for use or used as a fuel in a diesel powered highway vehicle or diesel powered train and not for a nontaxable use. In addition, such fuels are taxable if used in the production of a blended taxable fuel.[63]

The Code provides per-gallon tax incentives relating to biodiesel fuel used in a qualified mixture. The taxpayer has the option of taking the credit amount as an income tax credit, excise tax credit against the tax imposed on taxable fuels ("section 4081 liability") or as a payment from the Secretary in the amount of the credit. The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is $1.00 per gallon. No credit is allowed unless the taxpayer obtains a certification from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. Pursuant to Treasury Notice, a mixture of 99.9 percent biodiesel and diesel fuel is considered a mixture but such mixture is not a blended taxable fuel because it contains less than four percent paraffin content. Thus, while eligible for the biodiesel fuel mixture tax credit and payment provisions, such fuel would not be subject to tax until put in a motor vehicle for a taxable use.

The Code also provides per-gallon tax incentives relating to alcohol used in a qualified mixture. A qualified mixture means a mix-

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[59] Sec. 4081(a)(1)(B).
[60] Sec. 4083(a).
[61] Sec. 4083(a)(3).
[62] Treas. Reg. sec. 48.4081–1(c)(2)(ii).
[63] Under Treas. Reg. sec. 48.4081–1(c), blended taxable fuel generally means any taxable fuel that (1) is produced outside the bulk transfer/terminal system and (2) by mixing taxable fuel with respect to which tax has been imposed under sec. 4081(a)(gasoline, diesel fuel, or kerosene) with any other liquid on which tax has not been imposed under sec. 4081.

ture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The credit is 51 cents if the alcohol is ethanol (60 cents in the case of other alcohols).

REASONS FOR CHANGE

The Committee notes that when it enacted the credit for qualified biodiesel fuel mixtures, it intended that the resulting mixture of biodiesel and diesel fuel would be a taxable fuel and that the credit would be taken against the tax imposed on that fuel if not used for a nontaxable purpose. For biodiesel not in a mixture, it was intended that tax be imposed on the fuel when it was sold at retail into the fuel tank of a motor vehicle. It has come to the Committee's attention that persons are exploiting the Treasury Notice by adding minute amounts of diesel fuel to biodiesel in order to claim the full amount of credit for biodiesel fuel mixtures, while not paying any tax on the fuel because it does not meet the regulatory definition of diesel fuel. The Committee believes that such exploitation occurs to avoid both the imposition of tax and the more restrictive rules governing biodiesel that is not in a mixture, which require that the fuel be sold as motor fuel. The Committee believes it is consistent with Committee intent and appropriate to subject such fuel mixtures eligible for the fuel mixture credits to the taxes applicable to diesel fuel (taxes applicable to gasoline in the case of a mixture of alcohol and special fuel).

EXPLANATION OF PROVISION

The provision adds qualified alcohol fuel mixtures and qualified biodiesel fuel mixtures to the definition of taxable fuel. The proposal also requires the Secretary to require producers of these mixtures to file information reports with the Secretary.

The provision modifies the certification requirements for biodiesel. In addition to certifying that the product meets the statutory definition of biodiesel and identifying the percentage of biodiesel and agri-biodiesel in the product, the provision also requires the importer or producer to provide documentation that the biodiesel was tested by an independent laboratory and found to meet the requirements of ASTM D6751.

EFFECTIVE DATE

The provision is effective for fuels removed, entered, or sold after December 31, 2007.

O. EXTENSION AND MODIFICATION OF THE ALTERNATIVE FUEL CREDITS

(Sec. 331 of the bill and sec. 6426 and 6427 of the Code)

PRESENT LAW

The Code provides two per-gallon excise tax credits with respect to alternative fuel, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process, or liquid hydrocarbons derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

The alternative fuel credit is allowed against section 4041 liability and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents [64] of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel or used by the taxpayer for use as a fuel. The credits generally expire after September 30, 2009.

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after September 30, 2009.

With respect to liquefied hydrogen, the credit and payment provisions expire after September 30, 2014. Under coordination rules, a claim for payment or credit may only be taken once with respect to any particular gallon or gasoline-gallon equivalent of alternative fuel.

REASONS FOR CHANGE

The Committee believes it is appropriate to extend the alternative fuel excise tax credits to encourage the production and use of these fuels. However, the Committee is concerned with the carbon emissions from coal facilities and the impact of such emissions on the environment. Therefore, the provision imposes a carbon sequestration requirement for facilities producing liquid fuel from coal as a condition of credit eligibility.

EXPLANATION OF PROVISION

The provision extends the alternative fuel excise tax credit, alternative fuel mixture excise tax credit and related payment provisions through December 31, 2010, for all fuels other hydrogen. The incentives for hydrogen are unchanged by the proposal and will expire as provided under present law. The provision provides that biomass gas qualifies for the credit. The provision also provides that alternative fuel that is not in a mixture may be used, or sold for use, as a fuel in aviation for purposes of the credit.

Beginning on the date of enactment, to qualify as an alternative fuel, liquid fuel from coal derived through the Fischer-Tropsch process must be certified as having been derived from coal produced at a gasification facility that separates and sequesters at least 50 percent of such facilities total carbon dioxide emissions. The sequestration requirement increases to 75 percent on the earlier of (1) December 31, 2010, or (2) the date the Secretary determines that, taking into account the recommendations of the Carbon

[64] "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel, the amount of such fuel having a Btu content of 124,800 (higher heating value).

Sequestration Capability Panel, the sequestration rate should be 75 percent.

The Carbon Sequestration Capability Panel is composed of one individual appointed by the National Academy of Sciences, one individual appointed by the Chairman of the Committee on Finance in consultation with the Ranking member of the Committee, and one individual jointly appointed by the other two members. The panel is to submit to the Secretary, the Senate Committee on Finance, and the House Committee on Ways and Means a report regarding the appropriate percentage of carbon dioxide sequestration for purposes of liquid fuel derived from coal through the Fischer Tropsch process. In preparing its report, the panel shall consider whether it is feasible to separate and sequester 75 percent of the carbon dioxide emissions of a facility and the costs and other factors associated with separating and sequestering such percentage of carbon dioxide emissions. The report is to be submitted on the date that is six months after the date of enactment. The Secretary is to make his determination within 30 days of receiving the report.

EFFECTIVE DATE

The provision is effective for fuel sold or used after date of enactment.

P. Extension of Alternative Fuel Vehicle Refueling Property Credit

(Sec. 332 of the bill and sec. 30C of the Code)

PRESENT LAW

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.[65] The credit may not exceed $30,000 per taxable year per location in the case of qualified refueling property used in a trade or business and $1,000 per taxable year in the case of qualified refueling property installed on property which is used as a principal residence.

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

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

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for 1 year and forward for 20 years. Credits for residential

[65] Sec. 30C.

qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

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

The credit is available for property placed in service after December 31, 2005, and (except in the case of hydrogen refueling property) before January 1, 2010. In the case of hydrogen refueling property, the property must be placed in service before January 1, 2015.

REASONS FOR CHANGE

The Committee believes that building additional renewable fuel infrastructure advances America's environmental and energy independence goals and for this reason want to extend the tax incentive for alternative fuel refueling property.

EXPLANATION OF PROVISION

The provision extends for one year (through 2010) the credit for installing non-hydrogen alternative fuel refueling property.

EFFECTIVE DATE

The provision is effective for property placed in service after the date of enactment, in taxable years ending after such date.

TITLE IV—AGRICULTURAL PROVISIONS

A. Qualified Small Issue Bonds for Farming

(Sec. 401 of the bill and sec. 147 of the Code)

PRESENT LAW

Qualified small issue bonds are tax-exempt bonds issued by State and local governments to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain first-time farmers. A first-time farmer means any individual who has not at any time had any direct ownership interest in substantial farmland in the operation of which such individual materially participated. In addition, an individual does not qualify as a first-time farmer if such individual has received more than $250,000 in qualified small issue bond financing. Substantial farmland means any parcel of land unless (1) such parcel is smaller than 30 percent of the median size of a farm in the county in which such parcel is located and (2) the fair market value of the land does not at any time while held by the individual exceed $125,000.

REASONS FOR CHANGE

The Committee notes that the loan limits for first-time farmers have not been increased in more than two decades. Similarly, the rules relating to the definition of substantial farmland have not been increased in many years and, as a result, have not kept pace with increases in land prices. Thus, the Committee believes the tax-exempt bond rules for first-time farmers should be updated.

EXPLANATION OF PROVISION

The provision increases the maximum amount of qualified small issue bond proceeds available to first-time farmers to $450,000 and indexes this amount for inflation. The provision also eliminates the fair market value test from the definition of substantial farmland.

EFFECTIVE DATE

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

B. MODIFICATION OF INSTALLMENT SALE RULES FOR CERTAIN FARM PROPERTY

(Sec. 402 of the bill and sec. 453 of the Code)

PRESENT LAW

Taxpayers are permitted to recognize as gain on a disposition of property only that proportion of payments received in a taxable year that is the same as the proportion that the gross profit bears to the total contract price (the "installment method").[66] Notwithstanding this general rule, with respect to any installment sale, the aggregate amount that would be treated as ordinary income under section 1245 or section 1250 for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition ("recapture income") is recognized in the year of the disposition.[67]

REASONS FOR CHANGE

The Committee believes that the provision will encourage the sale of farms to younger farmers that may not otherwise qualify for traditional financing. While this proposal changes the rules for the seller, it is expected to help buyers by making the installment rules more favorable to sellers.

EXPLANATION OF PROVISION

The provision repeals the immediate recognition of recapture income for sales of any single purpose agricultural or horticultural structure (as defined in section 168(i)(13)) or any tree or vine bearing fruit or nuts.[68]

EFFECTIVE DATE

The provision is effective for installment sales after the date of enactment.

[66] Sec. 453.
[67] Sec. 453(i).
[68] This property is 10-year property described in section 168(e)(3)(D).

C. ALLOWANCE OF SECTION 1031 TREATMENT FOR EXCHANGES INVOLVING CERTAIN MUTUAL DITCH, RESERVOIR, OR IRRIGATION COMPANY STOCK

(Sec. 403 of the bill and sec. 1031 of the Code)

PRESENT LAW

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment.[69] If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange. In general, section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[70]

REASONS FOR CHANGE

The Committee believes that section 1031 should be clarified to remove any doubt that an exchange of shares in mutual ditch, reservoir, and irrigation company stock qualifies for tax deferral treatment under section 1031. The Committee intends this clarification would be for cases in which the highest court or statute of the State in which the company is organized recognize such shares as constituting or representing real property or an interest in real property.

EXPLANATION OF PROVISION

The provision provides that the general exclusion from section 1031 treatment for stocks shall not apply to shares in a mutual ditch, reservoir, or irrigation company, if at the time of the exchange: (1) the company is an organization described in section 501(c)(12)(A) (determined without regard to the percentage of its income that is collected from its members for the purpose of meeting losses and expenses); and (2) the shares in the company have been recognized by the highest court of the State in which such company was organized or by applicable State statute as constituting or representing real property or an interest in real property.

EFFECTIVE DATE

The provision is effective for transfers after the date of enactment.

[69] Sec. 1031(a)(1).
[70] Sec. 1031(a)(2).

D. RURAL RENAISSANCE BONDS

(Sec. 404 of the bill and new sec. 54A of the Code)

PRESENT LAW

Tax-exempt bonds

1. Subject to certain Code restrictions, interest on bonds issued by State and local government generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For this purpose, the term "nongovernmental person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[71] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[72] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal government.

An issuer of tax-exempt bonds must file with the IRS a return that provides certain information regarding the bond issuance.[73] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[74] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[75] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment

[71] Secs. 103(a) and (b)(2).
[72] Sec. 148.
[73] Sec. 149(e).
[74] Sec. 103(a) and (b)(2).
[75] Sec. 148.

profits that are earned during these periods or on such investments must be rebated to the Federal government.

Tax credit bonds

In general

As an alternative to traditional tax-exempt bonds, the Code permits three types of tax-credit bonds. States and local governments have the authority to issue qualified zone academy bonds ("QZABS"), clean renewable energy bonds ("CREBS"), and "Gulf tax credit bonds."[76]

A common feature of the present law tax-credit bonds is that the taxpayer holding such a bond receives a tax credit, rather than an interest payment. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the taxpayer's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

Clean renewable energy bonds

CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[77] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

In addition to the above requirements, at least 95 percent of the proceeds of CREBs must be spent on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem any "nonqualified bonds." The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the

[76] Secs. 1397E, 54, and 1400N(l), respectively.

[77] In addition, Notice 2006–7 provides that qualified projects include any facility owned by a qualified borrower that is functionally related and subordinate to any facility described in section 45(d)(1) through (d)(9) and owned by such qualified borrower.

failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

CREBs also are subject to the arbitrage requirements of section 148 that apply to tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to CREBs.

Issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. There is a national CREB limitation of $1.2 billion. The maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is $750 million. CREBs must be issued before January 1, 2009.

Qualified zone academy bonds

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

An issuer of QZABs must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified zone academy property within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified zone academy property during the five-year spending period, bonds will continue to qualify as QZABs if unspent proceeds are used within 90 days from the end of such five-year period to redeem any nonqualified bonds. For these purposes, the amount of nonqualified bonds is to be determined in the same manner as Treasury regulations under section 142. The provision provides that the five-year spending period may be extended by the Secretary if the issuer establishes that the failure to meet the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence.

A total of $400 million of qualified zone academy bonds is authorized to be issued annually in calendar years 1998 through 2007. The $400 million aggregate bond cap is allocated to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Issuers of QZABs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. In addition, QZABs are subject to the arbitrage requirements of section 148 that apply to tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to QZABs.

Gulf tax credit bonds

Gulf tax credit bonds may be issued by the States of Louisiana, Mississippi, and Alabama. To qualify as Gulf tax credit bonds, 95 percent or more of the proceeds of such bonds must be used to (i) pay principal, interest, or premium on a bond (other than a private activity bond) that was outstanding on August 28, 2005, and was issued by the State issuing the Gulf tax credit bonds, or any political subdivision thereof, or (ii) make a loan to any political subdivision of such State to pay principal, interest, or premium on a bond issued by such political subdivision. In addition, the issuer of Gulf tax credit bonds must provide additional funds to pay principal, interest, or premium on outstanding bonds equal to the amount of Gulf tax credit bonds issued to repay such outstanding bonds. Gulf tax credit bonds must be a general obligation of the issuing State and must be designated by the Governor of such State. The maximum maturity on Gulf tax credit bonds is two years. In addition, present-law arbitrage rules that restrict the ability of State and local governments to invest bond proceeds apply to Gulf tax credit bonds.

Gulf tax credit bonds must have been issued in calendar year 2006. The maximum amount of Gulf tax credit bonds authorized to be issued was $200 million in the case of Louisiana, $100 million in the case of Mississippi, and $50 million in the case of Alabama. Gulf tax credit bonds may not be used to pay principal, interest, or premium on any bond with respect to which there is any outstanding refunded or refunding bond. Moreover, Gulf tax credit bonds may not be used to pay principal, interest, or premium on any prior bond if the proceeds of such prior bond were used to provide any property described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale of alcoholic beverages for consumption off premises).

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

REASONS FOR CHANGE

The Committee believes that existing programs are not meeting the financing needs of rural communities. The Committee believes that additional incentives are needed to encourage economic development in rural areas. Thus, the Committee believes it is appropriate to provide rural communities with additional financing tools in order to promote investment in these underserved communities.

EXPLANATION OF PROVISION

The provision provides for a new category of tax-credit bonds, "Rural Renaissance Bonds." A Rural Renaissance Bond means any bond if: (1) the bond is issued by a qualified issuer pursuant to an allocation of the national limitation on such bonds; (2) 95 percent or more of the proceeds of the bond are to be used for capital expenditures incurred by qualified borrowers for one or more qualified projects; (3) the qualified issuer designates the bond as a Rural Renaissance Bond and such bond is issued in registered form; (4)

the bond meets the five-year spending requirement (described below); and (5) the bond is not Federally guaranteed (i.e., no portion of the bond is guaranteed in whole or in part by the United States).

Under the provision, the term "qualified issuer" means: (1) a rural renaissance bond lender; (2) a cooperative electric company; and (3) a governmental body. A "rural renaissance bond lender" means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002, including any affiliated lender which is controlled by such lender. The term "cooperative electric company" means a mutual or cooperative electric company (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act. The term "governmental body" means a State, territory, possession of the United States, the District of Columbia, Indian tribal government, and any political subdivision thereof. Under the provision, a "qualified borrower" means a cooperative electric company or a governmental body.

The term "qualified projects" means: (1) a utilities program described in section 381E(d)(2) of the Consolidated Farm and Rural Development Act; (2) a distance learning or telemedicine program authorized pursuant to chapter 1 of subtitle D of title XXIII of the Food, Agriculture, Conservation, and Trade Act of 1990; (3) the rural electric programs authorized pursuant to the Rural Electrification Act of 1936; (4) the rural telephone programs authorized pursuant to the Rural Electrification Act of 1936; (5) the broadband access programs authorized pursuant to title VI of the Rural Electrification Act of 1936; and (6) the rural community facility programs as described in section 381E(d)(1) of the Consolidated Farm and Rural Development Act.

As with present-law tax credit bonds, the taxpayer holding Rural Renaissance Bonds on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the taxpayer's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

Under the provision, at least 95 percent or more of the proceeds of Rural Renaissance Bonds must be spent on qualified projects within the five-year period that begins on the date of issuance of such bonds. To the extent less than 95 percent of the proceeds are spent as required during the five-year spending period, bonds will continue to qualify as Rural Renaissance Bonds only if unspent proceeds are used within 90 days from the end of such five-year period to redeem outstanding bonds. The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

The provision requires level amortization of Rural Renaissance Bonds during the period such bonds are outstanding. In addition, Rural Renaissance Bonds are subject to the arbitrage requirements of section 148 that apply to tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to Rural Renaissance Bonds.

The provision establishes a national limitation of $400,000,000 on the amount of bonds that may be designated as Rural Renaissance Bonds. The Secretary, in consultation with the Secretary of Agriculture, shall make allocations of the national limitation to at least 20 qualified projects, or such lesser number of qualified projects based on the number of applications filed 12 months after applications for allocations have been solicited by the Secretary. In addition, no more than 15 percent of the national limitation may be allocated to qualified projects located in any one State. Under the provision, Rural Renaissance Bonds may not be issued after December 31, 2008.

EFFECTIVE DATE

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

E. Agricultural Business Security Tax Credit

(Sec. 405 of the bill and sec. 45 of the Code)

PRESENT LAW

Present law does not provide a credit for agricultural business security.

REASONS FOR CHANGE

The Committee believes that a security tax credit would help the agricultural industry to properly safeguard agricultural pesticides and fertilizers from the threat of terrorists, drug dealers and other criminals. These safeguards are necessary to help alleviate a heightened concern as to the vulnerability of chemical storage facilities. This credit will help ease the substantial increase in production costs faced by agriculture related to installing improved security measures that will better protect the American public from the potential threat of terrorism or other illegal activities.

EXPLANATION OF PROVISION

The provision establishes a 30 percent credit for qualified chemical security expenditures for the taxable year with respect to eligible agricultural businesses. The credit is a component of the general business credit.[78]

The credit is limited to $100,000 per facility, this amount is reduced by the aggregate amount of the credits allowed for the facility in the prior five years. In addition, each taxpayer's annual credit is limited to $2,000,000.[79] The credit only applies to expenditures paid or incurred before December 31, 2012. The taxpayer's deductible expense is reduced by the amount of the credit claimed.

[78] Sec. 38(b)(1).

[79] The term taxpayer includes controlled groups under rules similar to the rules set out in section 41(f)(1) and (2).

Qualified chemical security expenditures are amounts paid by for: 1) employee security training and background checks; (2) limitation and prevention of access to controls of specific agricultural chemicals stored at a facility; (3) tagging, locking tank valves, and chemical additives to prevent the theft of specific agricultural chemicals or to render such chemicals unfit for illegal use; (4) protection of the perimeter of specified agricultural chemicals; (5) installation of security lighting, cameras, recording equipment and intrusion detection sensors (6) implementation of measures to increase computer or computer network security; (7) conducting security vulnerability assessments; (8) implementing a site security plan; and (9) other measures provided for by regulation. Amounts described in the preceding sentences are only eligible to the extent they are incurred by an eligible agricultural business for protecting specified agricultural chemicals.

Eligible agricultural businesses are businesses that: (1) sell agricultural products, including specified agricultural chemicals, at retail predominantly to farmers and ranchers; or (2) manufacture, formulate, distribute, or aerially apply specified agricultural chemicals.

Specified agricultural chemicals means: (1) are fertilizer commonly used in agricultural operations which is listed under section 302(a)(2) of the Emergency Planning and Community Right-to-know Act of 1986, section 101 or part 172 of title 49, Code of Federal Regulations, or part 126, 127 or 154 of title 33, Code of Federal Regulations; and (2) any pesticide (as defined in section 2(u) of the Federal Insecticide, Fungicide, and Rodenticide Act) including all active and inert ingredients which are used on crops grown for food, feed or fiber.

EFFECTIVE DATE

The provision is effective for expenses paid or incurred after date of enactment.

F. CREDIT FOR DRUG SAFETY AND EFFECTIVENESS TESTING FOR MINOR SPECIES

(Sec. 406 of the bill and new sec. 45P of the Code)

PRESENT LAW

Present law does not provide a credit for drug safety and effectiveness testing for use in a minor animal species.

REASONS FOR CHANGE

The Committee believes that insufficient resources are devoted to developing drugs for minor animal species such as sheep and goats. The Committee believes that a tax incentive for drug safety and effectiveness testing for use in minor animal species will encourage more investment in this area.

EXPLANATION OF PROVISION

The provision establishes, at the election of the taxpayer, a 50 percent credit for qualified safety and effectiveness testing expenses incurred during the taxable year for certain designated new animal drugs intended for use in a minor species. The taxpayer's otherwise deductible expenses are reduced by the amount of the credit claimed.

Safety and effectiveness testing is testing carried out under an exemption for a new animal drug for use on a minor species under section 512(j) of the Federal Food, Drug, and Cosmetic Act (or regulations issued under such section) (the "FFDC Act"). The testing must occur after a new animal drug request is filed for designation under section 573 of the FFDC Act but before the application with respect to such drug is approved under section 512(c) of such Act. Moreover, the testing must be conducted by or on behalf of the taxpayer who applied for the designation or by the owner of the animals that are the subject of the testing. Safety and effectiveness testing may be taken into account under the provision only to the extent such testing is related to the use of a new animal drug for the minor species for which it was designated under section 573 of FFDC Act.

A "minor species" means animals other than humans that are not major species. A "major species" means cattle, horses, swine, chickens, turkeys, dogs, and cats, as well as any species the Secretary, in consultation with the Secretary of Agriculture, adds by regulation.[80]

Qualified safety and effectiveness testing expenses comprise both in-house and contract expenses incurred by a taxpayer[81] in carrying on a trade or business or by a taxpayer that owns animals that are the subject of safety and effectiveness testing. For purposes of the provision, in-house expenses are (1) wages paid or incurred to an employee for safety and effectiveness testing or the direct supervision or support thereof; (2) any amount paid or incurred for supplies used in the conduct of safety and effectiveness testing; and (3) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of safety and effectiveness testing. Contract expenses are any amounts paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for safety and effectiveness testing.

Qualified safety and effectiveness testing expenses do not include amounts funded by any grant, contract, or otherwise by another person or government entity. In addition, qualified expenses will not be taken into account when determining the section 41 credit for research and experimentation except for purposes of calculating base period research expenses.

EFFECTIVE DATE

The provision is effective for expenses incurred after the date of enactment.

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[80] These definitions are intended to correspond with the definitions provided in section 201 of the FFDC Act.

[81] Under the provision, the term taxpayer includes controlled groups under rules similar to the rules set out in section 41(f)(1) and (2).

G. Farm Equipment Treated as Five-Year Property

(Sec. 407 of the bill and sec. 168 of the Code)

PRESENT LAW

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS").[82] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87–56.[83] Asset class 01.1 includes machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agricultural, animal husbandry, and horticultural services. These assets are assigned a class life of 10 years and a recovery period of seven years.

REASONS FOR CHANGE

The Committee believes that the depreciation incentive will provide important economic benefits to encourage development within the agricultural sector. The provision lowers the cost of capital for property used in agricultural trades or businesses which will lead to additional investment in more equipment and employment of more workers.

EXPLANATION OF PROVISION

The provision provides a five year recovery period for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business and placed in service before January 1, 2010, the original use of which begins with the taxpayer. For these purposes, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity.[84] A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.[85]

EFFECTIVE DATE

The provision is effective for original use property placed in service after the date of enactment.

[82] Sec. 168.
[83] 1987–2 C.B. 674 (as clarified and modified by Rev. Proc. 88–22, 1988–1 C.B. 785).
[84] Treas. Reg. sec. 1.263A–4(a)(4)(i).
[85] Treas. Reg. sec. 1.263A–4(a)(4)(ii).

H. Expensing of Broadband Internet Access Expenditures

(Sec. 408 of the bill and new sec. 191 of the Code)

PRESENT LAW

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS").[86] Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

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 Small Business and Work Opportunity Tax Act of 2007[87] increased the amount a taxpayer may deduct, for taxable years beginning in 2007 through 2010, to $125,000 of the cost of qualifying property placed in service for the taxable year.[88] 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 $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after 2007 and before 2011. For taxable years beginning in 2011 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed.

REASONS FOR CHANGE

The Committee believes that it is appropriate to provide the tax incentive of expensing to encourage the provision of broadband services through new or upgraded equipment. In particular, the Committee believes that the provision of such services should be encouraged in rural areas and areas in which residents tend to have incomes significantly lower than the median. Because some

[86] Sec. 168.

[87] Pub. L. No. 110–28, sec. 8212 (2007).

[88] 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)).

such areas may be served by current-generation broadband services, the tax incentive is provided with respect to current generation broadband services for residential subscribers if the area is not a saturated market. The expensing incentive is provided without regard to whether the local market is saturated, in the case of next generation broadband service, because of the Committee's desire to encourage wider availability of faster broadband service.

EXPLANATION OF PROVISION

The provision provides an election to treat any qualified broadband expenditure paid or incurred by the taxpayer as not chargeable to capital account, but rather, as a deduction. The deduction is allowed in the first taxable year in which either current generation or next generation broadband services are provided through qualified equipment to qualified subscribers. Expenditures are eligible for this election only for qualified equipment, the original use of which commences with the taxpayer. The provision applies for qualified broadband expenditures incurred after the date of enactment and on or before the first December 31 that is three years after such date.

"Current generation broadband services" are defined as the transmission of signals at a rate of at least 5 million bits per second to the subscriber and at a rate of at least 1 million bits per second from the subscriber. "Next generation broadband services" are defined as the transmission of signals at a rate of at least 100 million bits per second to the subscriber and at a rate of at least 20 million bits per second from the subscriber.

"Qualified broadband expenditures" means the direct or indirect costs properly taken into account for the taxable year for the purchase or installation of qualified equipment (including upgrades) and the connection of the equipment to a qualified subscriber. The term does not include costs of launching satellite equipment. For current generation broadband services, only 50 percent of the otherwise allowable amount of deduction is treated as qualified broadband expenditures.

Qualified broadband expenditures include only the portion of the purchase price paid by the lessor, in the case of leased equipment, that is attributable to otherwise qualified broadband expenditures by the lessee. In the case of property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was originally placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

A qualified subscriber, with respect to current generation broadband services, means any nonresidential subscriber maintaining a permanent place of business in a rural area or underserved area, or any residential subscriber residing in a rural area or underserved area that is not a saturated market. A qualified subscriber, with respect to next generation broadband services, means any nonresidential subscriber maintaining a permanent place of business in a rural area or underserved area, or any residential subscriber.

For this purpose, a rural area means any census tract not within 10 miles of an incorporated or census-designated place with more than 25,000 people and not within a county or county equivalent with overall population density of more than 500 people per square mile. An underserved area means a census tract located in an empowerment zone or enterprise community designated under section 1391 or the District of Columbia Enterprise Zone established under section 1400, or any census tract the poverty level of which is at least 30 percent and the median family income of which does not exceed (1) for a tract in a metropolitan statistical area, 70 percent of the greater of the metropolitan area median family income or the statewide median family income, and (2) for a tract that is not in a metropolitan statistical area, 70 percent of the nonmetropolitan statewide median family income.

A saturated market, for this purpose, means any census tract in which, as of the date of enactment, current generation broadband services have been provided by a single provider to 85 percent or more of the total potential residential subscribers. The services must be usable at least a majority of the time during periods of maximum demand, and usable in a manner substantially the same as services provided through equipment not eligible for the deduction under this provision.

If current, or next, generation broadband services can be provided through qualified equipment to both qualified subscribers and to other subscribers, the provision provides that the expenditures with respect to the equipment are allocated among subscribers to determine the amount of qualified broad broadband expenditures that may be deducted under the provision.

Qualified equipment means equipment that provides current, or next, generation broadband services at least a majority of the time during periods of maximum demand to each subscriber, and in a manner substantially the same as such services are provided by the provider to subscribers through equipment with respect to which no deduction is allowed under the provision. Limitations are imposed under the provision on equipment depending on where it extends, and on certain packet switching equipment, and on certain multiplexing and demultiplexing equipment.

Expenditures generally are not taken into account for purposes of the deduction under the provision with respect to property used predominantly outside the United States, used predominantly to furnish lodging, used by a tax-exempt organization (other than in a business whose income is subject to unrelated business income tax), or used by the United States or a political subdivision or by a possession, agency or instrumentality thereof or by a foreign person or entity. The basis of property is reduced by the cost of the property that is taken into account as a deduction under the provision. Recapture rules are provided. No business credit under section 38 is allowed with respect to any amount allowed as a deduction under the provision.

EFFECTIVE DATE

The provision is effective on the date of enactment and applies to expenditures incurred after the date of enactment and on or before the first December 31 that is three years after such date.

I. Credit for Energy Efficient Electric Motors

(Sec. 409 of the bill and new sec. 45Q of the Code)

PRESENT LAW

There is no present law credit for energy efficient electric motors.

REASONS FOR CHANGE

The Committee recognizes the need to reduce the consumption of electricity, both to mitigate the harmful effects of electricity generation from fossil fuels and to reduce demands on the electrical grid. The Committee has long recognized the potential to save energy from the promotion of more energy efficient products, and believes that the provision of a tax credit for energy efficient motors will increase the use of such motors and result in less electricity consumption

EXPLANATION OF PROVISION

The provision provides a business tax credit for the purchase of qualified energy efficient electric motors that meet or exceed certain energy efficiency standards. The credit equals $15 per horsepower and the aggregate amount of credit that a taxpayer may claim for any taxable year cannot exceed $1,250,000. A "qualifying energy efficient motor" is: (a) a general- or definite-purpose electric motor of 500 horsepower or less that meets or exceeds the efficiency levels specified in Tables 12–12 or 12–13 of the National Electrical Manufacturers Association MG–1 (2006); (b) the original use begins with the taxpayer; and (c) is placed in service in the United States. The provision applies to energy efficient motors placed in service after the date of enactment and prior to 36 months from the date of enactment.

The basis of any property for which a credit is allowable is reduced by the amount of the credit. The Secretary of the Treasury, by regulations, is to provide rules for recapturing the credit in the case of any property which ceases to be property eligible for the credit. No credit is allowed with respect to the portion of the cost of any property taken into account for expensing under section 179.

EFFECTIVE DATE

The provision is effective for property placed in service after the date of enactment and prior to 36 months from the date of enactment.

TITLE V—REVENUE RAISING PROVISIONS

A. Limitation on Farming Losses of Certain Taxpayers

(Sec. 501 of the bill and sec. 461 of the Code)

PRESENT LAW

Farming income and expenses are reported by individuals, estates, trusts, and partnerships on IRS Schedule F, Profit and Loss from Farming. For taxpayers who materially participate (as defined in section 469(h)), net farming losses are reported in full as a reduction to income from both passive and nonpassive sources. To the extent taxpayers do not materially participate in the farming activity, the passive activity rules in section 469 may limit the ability to use such losses to reduce income from nonpassive sources.

Farming income generally includes sales of livestock, produce, grains, and other products; cooperative distributions; Agricultural Program Payments; certain Commodity Credit Corporation ("CCC") loans (if an election is made to include loan proceeds in income in the year received); certain crop insurance proceeds and federal crop disaster payments; and other income. Farm expenses generally include feed, fertilizers, gasoline, fuel, and oil; insurance; interest; hired labor; rent and lease payments; repairs and maintenance; taxes; utilities; depreciation; and other business-related expenses. Living expenses and other personal expenses are not deductible farming expenses.

REASONS FOR CHANGE

The Committee believes that taxpayers receiving government assistance through payment programs and loan programs should not be allowed to claim unlimited amounts of losses from farming activities.

EXPLANATION OF PROVISION

The provision limits the amount of losses that can be claimed by an individual, estate, trust, or partnership on Schedule F to $200,000 in cases where the taxpayer has received Agriculture Program Payments or CCC loans. Losses that are limited in a particular year may be carried forward to subsequent years.

EFFECTIVE DATE

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

B. Increase and Index Dollar Thresholds for Farm Optional Method and Nonfarm Optional Method for Computing Net Earnings From Self-Employment

(Sec. 502 of the bill and sec. 1402(a) of the Code)

PRESENT LAW

In general

Generally, tax under the Self-Employment Contributions Act (SECA) is imposed on the self-employment income of an individual. SECA tax has two components. Under the old-age, survivors, and disability insurance component, the rate of tax is 12.40 percent on self-employment income up to the Social Security wage base ($97,500 for 2007). Under the hospital insurance component, the rate is 2.90 percent of all self-employment income (without regard to the Social Security wage base).

Self-employment income subject to the SECA tax is determined as the net earnings from self-employment. An individual may use one of three methods to calculate net earnings from self-employment. Under the generally applicable rule, net earnings from self-employment means gross income (including the individual's net distributive share of partnership 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 SECA tax rules. Alternatively, an individual may elect to use one of two optional methods for calculating net earnings from self-employment. These methods are: (1) the farm optional method; and (2) the nonfarm optional method. The farm optional method allows individuals to pay SECA taxes (and secure Social Security benefit coverage) when they have low net income or losses from farming. The nonfarm optional method is similar to the farm optional method.

Farm optional method

If an individual is engaged in a farming trade or business, either as a sole proprietor or as a partner, the individual may elect to use the farm optional method in one of two instances. The first instance is an individual engaged in a farming business who has gross farm income of $2,400 or less for the taxable year. In this instance, the individual may elect to report two-thirds of gross farm income as net earnings from self-employment. In the second instance, an individual engaged in a farming business may elect the farm optional method even though gross farm income exceeds $2,400 for the taxable year but only if the net farm income is less than $1,733 for the taxable year. In this second instance, the individual may elect to report $1,600 as net earnings from self-employment for the taxable year. In all other instances (i.e., more than $2,400 of gross farm income and net farm income of at least $1,733) a person engaged in a farming business must compute net earnings from self-employment under the generally applicable rule. There is no limit on the number of years that an individual may elect the farm optional method during such individual's lifetime.

The dollar limits in the farm optional method are not indexed for inflation.

Nonfarm optional method

The nonfarm optional method is available only to individuals who have been self-employed for at least two of the three years before the year in which they seek to elect the nonfarm optional method and who meet certain other requirements. Specifically, an individual may elect the nonfarm optional method if the individual's: (1) net nonfarm income for the taxable year is less than $1,733; and (2) net nonfarm income for the taxable year is less than 72.189 percent of gross nonfarm income. If a qualified individual engaged in a nonfarming business who elects the nonfarm optional method has gross nonfarm income of $2,400 or less for the taxable year, then the individual may elect to report two-thirds of gross nonfarm income as net earnings from self-employment. If the electing individual engaged in a nonfarming business has gross nonfarm income of at least $2,400 for the taxable year, then the individual may elect to report $1,600 as net earnings from self-employment for the taxable year. In all other instances, a person engaged in a nonfarming business must compute net earnings from self-employment under the generally applicable rule. An individual may elect to use the nonfarm optional method for no more than five years in the course of the individual's lifetime.

The dollar limits in the nonfarm optional method are not indexed for inflation.

Other rules applicable to farm optional and nonfarm optional methods

In the case of a cash method trade or business, gross income is defined as the gross receipts from such trade or business less the cost or other basis of property sold in carrying out such trade or business with certain adjustments. In the case of an accrual method trade or business, gross income is defined as the gross income from the trade or business with certain adjustments. If an individual (including a member of a partnership) derives gross income from more than one trade or business then such gross income (including the individual's distributive share of the gross income of any partnership) is treated as derived from a single trade or business.

Social Security benefit eligibility

Generally, Social Security benefits can be paid to an individual (and dependents or survivors) only if that individual has worked long enough in covered employment to be insured. Insured status is measured in terms of "credits," previously called "quarters of coverage." For this purpose, Social Security uses the lifetime record of earnings reported for that individual. In the case of a self-employed individual, net earnings from self-employment is used to calculate Social Security benefit eligibility.

Up to four quarters of coverage can be earned for a year, depending on covered wages for the year and the amount needed to earn each quarter of coverage. For 2007, credit for a quarter of coverage is provided for each $1,000 of wages.

REASONS FOR CHANGE

The Committee believes that taxpayers should have the ability to earn four quarters of coverage for Social Security benefits annually under either the farm optional method or nonfarm optional method. Because the present-law dollar amounts are not updated or indexed for inflation otherwise eligible taxpayers have lost that ability. The bill makes needed changes to those methods and ensures that they are indexed so the problem will not reoccur in the future.

DESCRIPTION OF PROPOSAL

The provision modifies the farm optional method so that electing taxpayers may be eligible to secure four credits of Social Security benefit coverage each taxable year by increasing an indexing the thresholds. The provision makes a similar modification to the nonfarm optional method.

EFFECTIVE DATE

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

C. Information Reporting for Commodity Credit Corporation Transactions

(Sec. 503 of the bill and new sec. 6039J of the Code)

PRESENT LAW

The Farm Security and Rural Investment Act of 2002[89] authorizes a marketing assistance loan program through the Commodity Credit Corporation ("CCC"). Under such program, the CCC may make loans for eligible commodities at a specified rate per unit of commodity (the original loan rate). The repayment amount for such a loan secured by an eligible commodity generally is based on the lower of the original loan rate or the alternative repayment rate, as determined by the CCC, as of the date of repayment. The alternative repayment rate may be adjusted to reflect quality and location for each type of commodity. A taxpayer receiving a CCC loan can use cash to repay such a loan, purchase CCC certificates for use in repayment of the loan, or deliver the pledged collateral as full payment for the loan at maturity.

If a taxpayer uses cash or CCC certificates to repay a CCC loan, and the loan is repaid at a time when the repayment rate is less than the original loan rate, the difference between the original loan amount and the lesser repayment amount is market gain. Regardless of whether a taxpayer repays a CCC loan in cash or uses CCC certificates in repayment of the loan, the market gain is taken into account either as income or as an adjustment to the basis of the commodity (if the taxpayer has made an election under section 77).

If a farmer uses cash instead of certificates, the farmer will receive a Form CCC–1099–G Information Return showing the market gain realized. For transactions prior to January 1, 2001, however, if a farmer uses CCC certificates to facilitate repayment of a CCC loan, the farmer will not receive an information return. For transactions after January 1, 2001, IRS Notice 2007–63 provides that the CCC reports market gain associated with the repayment of a CCC loan whether the taxpayer repays the loan with cash or uses CCC certificates in repayment of the loan.[90] The CCC reports the market gain on Form 1099–G, Certain Government Payments.

REASONS FOR CHANGE

Income that is subject to information reporting is less likely to be underreported. In contrast, the absence of information reporting on many types of payments results in underreporting and contributes to the tax gap.[91] Thus, the Committee believes it is important to ensure that information reporting rules are applied consistently to payments that may differ in form, but are economically equivalent. For this reason, the Committee believes it is appropriate to codify the IRS's administrative determination regarding information reporting for the repayment of CCC loans.

[89] Pub. L. No. 107–171.
[90] 2007–33 IRB.
[91] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely.

EXPLANATION OF PROVISION

The provision codifies the requirements of IRS Notice 2007–63 providing that the CCC reports market gain associated with the repayment of a CCC loan, regardless of whether the taxpayer repays the loan with cash or uses CCC certificates in repayment of the loan.

EFFECTIVE DATE

The provision is effective for loans repaid on or after January 1, 2007.

D. Modification of Section 1031 Treatment for Certain Real Estate

(Sec. 504 of the bill and sec. 1031 of the Code)

PRESENT LAW

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for productive use in a trade or business or for investment.[92] If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange. For purposes of section 1031, the determination of "like kind" relates to the nature or character of the property and not its grade or quality.[93] Therefore, improved real estate and unimproved real estate are generally considered to be property of a "like kind" as this distinction relates to the grade or quality of the real estate.[94]

REASONS FOR CHANGE

The Committee believes that sellers are currently using section 1031 to defer gains on improved real estate exchanged for farm property and also receiving the benefit of the farm property's historical agricultural base involved in calculating Agriculture Program Payments to include direct payments and counter cyclical payments. The Committee believes that those exchanges should not be like kind.

EXPLANATION OF PROVISION

The provision modifies section 1031 to disallow nonrecognition treatment for exchanges of unimproved real estate for which the owner is receiving Agriculture Program Payments or Commodity Credit Corporation ("CCC") loans for improved real estate, unless the undeveloped land is permanently retired from farm program payments.

[92] Sec. 1031(a)(1).
[93] Treas. Reg. sec. 1.1031(a)–1(b).
[94] Treas. Reg. sec. 1.1031(a)–1(c).

EFFECTIVE DATE

The provision is effective for exchanges completed after the date of enactment.

E. MODIFICATION OF EFFECTIVE DATE OF LEASING PROVISIONS OF THE AMERICAN JOBS CREATION ACT OF 2004

(Sec. 505 of the bill and sec. 470 of the Code)

PRESENT LAW

Present law provides for the deferral of losses attributable to certain tax exempt use property, generally effective for leases entered into after March 12, 2004. The deferral provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application: (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004; (2) was approved by the Federal Transit Administration before January 1, 2006; and (3) includes a description and the fair market value of such property (the "qualified transportation property exception").

REASONS FOR CHANGE

The Committee is aware that certain leasing transactions entered into with foreign lessees prior to March 12, 2004, are continuing to provide a tax benefit to the taxpayers who participated in such transactions. The Committee finds these transactions and their continuing tax benefit to be inappropriate.

EXPLANATION OF PROVISION

The provision changes the effective date of the loss deferral rules with respect to certain leases. Under the provision, the loss deferral rules also apply to leases entered into on or before March 12, 2004, if the lessee is a foreign person or entity. With respect to such leases, losses are deferred starting in taxable years beginning after December 31, 2006.

No inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to March 12, 2004, if the lessee is not a foreign person or entity. In addition, it is intended that the provision shall not be construed as altering or supplanting the present-law tax rules providing that a taxpayer is treated as the owner of leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property, including the benefits and burdens of ownership. The provision also is not intended to affect the scope of any other present-law tax rules or doctrines applicable to purported leasing transactions.

EFFECTIVE DATE

The provision is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which it relates.

F. Modifications to Corporate Estimated Tax Payments

(Sec. 506 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.

Under present law, in the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 115.00 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

REASONS FOR CHANGE

The Committee believes it is appropriate to adjust the corporate estimated tax payments.

EXPLANATION OF PROVISION

The bill increases the otherwise applicable percentage (115.00 percent) by 7.00 percent.

EFFECTIVE DATE

The provision is effective on the date of enactment.

G. Ineligibility of Collectibles for Nontaxable Like Kind Exchange Treatment

(Sec. 507 of the bill and sec. 1031 of the Code)

PRESENT LAW

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for productive use in a trade or business or for investment.[95] If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange. For purposes of section 1031, the determination of "like kind" relates to the nature or character of the property and not its grade or quality. "One kind or class of property may not, under that section, be exchanged for property of a different kind or class."[96]

REASONS FOR CHANGE

The Committee believes that section 1031 was designed to encourage capital reinvestment for assets used in a trade or business or held for investment. Because collectibles have elements of both

[95] Sec. 1031(a)(1).
[96] Treas. Reg. sec. 1.1031(a)–1(b).

investment and personal use, the Committee wishes to exclude collectibles from property qualifying for nonrecognition treatment.

EXPLANATION OF PROVISION

The provision denies nonrecognition treatment for exchanges of collectibles, as defined by section 408(m)(2).

EFFECTIVE DATE

The provision is effective for exchanges completed after the date of enactment.

H. Denial of Deduction for Certain Fines, Penalties, and Other Amounts

(Sec. 508 of the bill and sec. 162(f) and new sec. 6050W of the Code)

PRESENT LAW

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment to a government of a fine or similar penalty for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[97]

Treasury regulation section 1.162–21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162–21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. sec. 15a), as amended) paid to a government do not constitute a fine or penalty.

REASONS FOR CHANGE

The Committee is concerned that there is a lack of clarity and consistency under present law regarding when taxpayers may deduct payments made in settlement of government investigations of potential wrongdoing, as well as in situations where there has been a final determination of wrongdoing. If a taxpayer deducts payments made in settlement of an investigation of potential wrongdoing or as a result of a finding of wrongdoing, the publicly announced amount of the settlement payment does not reflect the true after-tax penalty on the taxpayer. The Committee also is con-

[97] S. Rep. No. 91–552, 91st Cong, 1st Sess., 273–74 (1969), referring to Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

cerned that allowing a deduction for such payments in effect shifts a portion of the penalty to the Federal government and to the public.

EXPLANATION OF PROVISION

The provision modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the provision generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law, or the investigation or inquiry into the potential violation of any law which is initiated by such government,[98] are nondeductible under any provision of the income tax provisions.[99] The provision applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) for damage or harm caused by, or which may be caused by, the violation or potential violation, or amounts paid to come into compliance with any law that was violated or involved in the investigation or inquiry. The exception for restitution does not apply to any amount paid or incurred as reimbursement to the government for the costs of any investigation or litigation[100] unless such amount is paid or incurred for a cost or fee regularly charged for any routine audit or other customary review performed by the government.[101]

In the case of any court order or binding written settlement agreement, if the amounts required to be paid exceed $1 million, then the deduction is not allowed unless such court order or written settlement agreement specifies that the amount is for restitution, for remediation of property, or to come into compliance with the law.[102] The IRS remains free to challenge the characterization of an amount so identified.[103]

The provision does not apply to any amount paid or incurred by order of a court in a suit in which no government is a party.[104]

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[98] The provision does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the provision would affect that payment.

[99] The provision provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[100] This exception from deductibility for reimbursements is intended to include payments to reimburse a government for payments to whistleblowers.

[101] The provision does not affect such costs or fees that are a regular charge for a routine audit or customary review, nor does it affect amounts paid or incurred in performing routine audits or reviews that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the provision would affect that payment.

[102] The provision does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which continue to be governed by the provisions of section 162(g).

[103] If a settlement agreement does not specify a specific amount to be paid for the purpose of coming into compliance but instead simply requires the taxpayer to come into compliance, it is sufficient identification to so state. Amounts expended by the taxpayer for that purpose would then be considered identified. However, if an agreement specifies a specific dollar amount that must be paid or incurred, the amount would not be eligible to be deducted without a specification that it is for restitution (including remediation of property) or coming into compliance.

[104] Thus, for example, the provision would not apply to payments made by one private party to another in a lawsuit between private parties merely because a judge or jury acting in the capacity as a court ddirects the payment to be made. The mere fact that a court enters a judg-

The provision does not apply to any amount paid or incurred as taxes due.[105]

It is intended that a payment will be treated as restitution (including remediation of property) only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution or included remediation of property.[106] Restitution and included remediation of property is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution and included remediation of property includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm.

It is intended that a payment will be treated as an amount paid to come into compliance only if it directly corrects a violation with respect to a particular requirement of law that was under investigation. For example, if the law requires a particular emission standard to be met or particular machinery to be used, amounts required to be paid under a settlement agreement to meet the required standard or install the machinery are deductible to the extent otherwise allowed. Similarly, if the law requires certain practices and procedures to be followed and a settlement agreement requires the taxpayer to pay to establish such practices or procedures, such amounts would be deductible. However, amounts paid for other purposes not directly correcting a violation of law are not deductible. For example, amounts paid to bring other machinery that is already in compliance up to a standard higher than required by the law, or to create other benefits (such as a park or other action not previously required by law), are not deductible if required under a settlement agreement. Similarly, amounts paid to educate consumers or customers about the risks of doing business with the taxpayer or about the field in which the taxpayer does business generally, which education efforts are not specifically required under the law, are not deductible if required under a settlement agreement.

The provision requires government agencies to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered where the aggregate amount required to be paid or incurred to or at the direction of the government under such settlement agreements and orders with respect to the violation, investigation, or inquiry is least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure

ment or directs a result in a private dispute does not cause a payment to be made "at the direction of a government" for purposes of the provision.

[105] Thus, amounts paid or incurred as taxes due are not affected by the provision (e.g., State taxes that are otherwise deductible). The reference to taxes due is also intended to include interest with respect to such taxes (but not interest, if any, with respect to any penalties imposed with respect to such taxes).

[106] Similarly, a payment to a charitable organization benefiting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the provision, such a payment not deductible under section 162 would also not be deductible under section 170.

the efficient administration of the Internal Revenue laws). The reports must be made within 30 days of the date the court order is issued or the settlement agreement is entered into, or such other time as may be required by Secretary. The report must separately identify any amounts that are restitution or remediation of property, or correction of noncompliance.[107]

The IRS is encouraged to require taxpayers to identify separately on their tax returns the amounts of any such settlements with respect to which reporting is required under the provision, including separate identification of the nondeductible amount and of any amount deductible as restitution, remediation, or required to correct noncompliance.[108]

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are paid or incurred for restitution, remediation of property, or coming into compliance; the rules requiring identification of those amounts in a court order or written settlement agreement of $1 million or greater; and all the other requirements of the provision including the requirement of reporting to the IRS and the taxpayer, likewise apply in such cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the provision is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

EFFECTIVE DATE

The provision is effective for amounts paid or incurred on or after the date of enactment; however the provision does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained before the date of enactment.

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[107] As in the case of the identification requirement, if the agreement does not specify a specific amount to be expended to come into compliance but simply requires that to occur, it is expected that the report may state simply that the taxpayer is required to come into compliance but no specific dollar amount has been specified for that purpose in the settlement agreement.

[108] For example, the IRS might require such separate reporting as part of, or in addition to, reporting of amouts that are not deducted and that thus create a book tax difference on the schedule M–3.

I. Increase In Information Return Penalties

(Sec. 509 of the bill and secs. 6721, 6722, and 6723 of the Code)

PRESENT LAW

Present law imposes information reporting requirements on participants in certain transactions. Under section 6721 of the Code, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date, but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return (the "first-tier penalty"), with a maximum penalty of $75,000 per calendar year. If a person files a correct information return more than 30 days after the prescribed filing date, but on or before August 1, the amount of the penalty is $30 per return (the "second-tier penalty"), with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, the amount of the penalty is $50 per return (the "third-tier penalty"), with a maximum penalty of $250,000 per calendar year.

Special lower maximum levels for this penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Section 6722 of the Code also imposes penalties for failing to furnish correct payee statements to taxpayers. In addition, section 6723 imposes a penalty for failing to comply with other information reporting requirements. Under both section 6722 and section 6723, the penalty amount is $50 for each failure, up to a maximum of $100,000.

REASONS FOR CHANGE

The Committee believes the present law penalties for failing to file accurate information returns are too low to discourage noncompliance. The Committee believes that increasing the information return penalties will encourage the filing of timely and accurate information returns and generally will improve tax administration and tax compliance.

EXPLANATION OF PROVISION

The provision increases the penalties for failing to file correct information returns, failing to furnish correct payee statements, and failing to comply with other information reporting requirements. Specifically, the provision increases the failure to file correct information returns as follows: the first-tier penalty would be increased from $15 to $50, with a maximum penalty of $500,000 per calendar year; the second-tier penalty would be increased from $30 to $100, with a maximum penalty of $1,500,000 per calendar year; and the third-tier penalty would be increased from $50 to $250, with a maximum penalty of $3,000,000 per calendar year. The maximum penalties for small businesses would be: $175,000 if the failures are corrected on or before 30 days after the prescribed filing date; $500,000 if the failures are corrected on or before August 1; and $1,000,000 if the failures are not corrected on or before August 1.

The provision increases both the penalty for failing to furnish correct payee statements to taxpayers and the penalty for failing to comply with other information reporting requirements penalties to $250 for each such failure, up to a maximum of $1,000,000 in a calendar year.

EFFECTIVE DATE

The provision is effective with respect to information returns required to be filed on or after January 1, 2008.

J. ECONOMIC SUBSTANCE DOCTRINE

(Secs. 511–513 of the bill and sec. 7701, new sec. 6662B, and sec. 163 of the Code)

1. Clarification of the economic substance doctrine

PRESENT LAW

In general

The Code provides detailed rules specifying the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss, and deduction. These rules permit both taxpayers and the government to compute taxable income with reasonable accuracy and predictability. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, they can be seen as at odds with an objective, "rule-based" system of taxation.

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[109]

[109] See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997), cert. denied 526 U.S. 1017 (1999). Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine." See, e.g., Knetsch v. United States, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions). Certain "substance over form" cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed. See, e.g., Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Texas

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations—notwithstanding that the purported activity actually occurred. The Tax Court has described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[110]

Business purpose doctrine

A common law doctrine that often is considered together with the economic substance doctrine is the business purpose doctrine. The business purpose doctrine involves a subjective inquiry into the motives of the taxpayer—that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[111]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[112] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[113] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.[114] A third ap-

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2007); TIFD–III–E, Inc. v. United States, 459 F. 3d 220 (2d Cir. 2006); BB&T Corporation v. United States, ——F. Supp. 2d ——, 2007–1 USTC P 50,130 (M.D.N.C. 2007).

[110] AACM Partnership v. Commissioner, 73 T.C.M. at 2215.

[111] See, ACM Partnership v. Commissioner, 157 F.3d at 256 n.48.

[112] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." Collins v. Commissioner, 857 F.2d 1383, 1386 (9th Cir. 1988).

[113] See, e.g., Pasternak v. Commissioner, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[114] See, e.g., Rice's Toyota World v. Commissioner, 752 F.2d 89, 91–92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); IES Industries v. United States, 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test)."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, Study of Present-Law Penalty and Interest Provisions as Required by Section 3801

Continued

proach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[115]

Recently, the Court of Federal Claims questioned the continuing viability of the doctrine. That court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers" though that court also found that the particular case did not lack economic substance. The Court of Appeals for the Federal Circuit ("Federal Circuit Court") overruled the Court of Federal Claims decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in question violated that doctrine.[116] The Federal Circuit Court stated that "[w]hile the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, [footnote omitted], a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." [117]

Nontax economic benefits

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to satisfy economic substance. Some courts have denied tax benefits on the grounds that a stated business benefit of a particular structure was not in fact obtained by that structure.[118] Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[119] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[120] Under this analysis, the taxpayer's profit potential

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of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters) (JCS–3–99) at 182.

[115] 1ASee, e.g., ACM Partnership v. Commissioner, 157 F.3d at 247; James v. Commissioner, 899 F.2d 905, 908 (10th Cir. 1995); Sacks v. Commissioner, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[116] Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (2004) (slip opinion at 123–124, 128); vacated and remanded, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (Mem.) (2007).

[117] The Federal Circuit Court stated that "when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." The Federal Circuit Court quoted a decision of its predecessor court, stating that "Gregory v. Helvering requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance." The Court also stated that "while the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of a transaction in assessing its economic substance." Coltec Industries, Inc. v. United States, 454 F.3d at 1355, 1356.

[118] See, e.g., Coltec Industries v. United States, 454 F.3d 1340 (Fed. Cir. 2006). The court analyzed the transfer to a subsidiary of a note purporting to provide high stock basis in exchange for a purported assumption of liabilities, and held these transactions unnecessary to accomplish any business purpose of using a subsidiary to manage asbestos liabilities. The court also held that the purported business purpose of adding a barrier to veil-piercing claims by third parties was not accomplished by the transaction. 454 F.3d at 1358–1360 (Fed. Cir. 2006).

[119] See, e.g., Knetsch, 364 U.S. at 361; Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

[120] See, e.g., Goldstein v. Commissioner, 364 F.2d at 739–40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); Sheldon v.

must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[121] In these cases, in assessing whether a reasonable possibility of profit exists, it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least one court has concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.[122] However, based on court decisions that recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.[123]

Tax-indifferent parties

A number of cases have involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax indifferent party from the transaction. Courts have sometimes concluded that a particular type of transaction did not satisfy the economic substance doctrine.[124] In other cases, courts have indicated that the substance of the transaction did not support the form of income allocations asserted by the taxpayer, and have questioned whether asserted business purpose or other standards were met.[125]

REASONS FOR CHANGE

Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by the Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining overall respect for the tax system.

A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be

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Commissioner, 94 T.C. 738, 768 (1990) (stating that "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[121] See, e.g., Rice's Toyota World v. Commissioner, 752 F. 2d 89, 94 (4th Cir. 1985) (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 781 (5th Cir. 2001) (applied the same test, citing Rice's Toyota World); IES Industries v. United States, 253 F.3d 350, 354 (8th Cir. 2001).

[122] See American Electric Power, Inc. v. United States, 136 F. Supp. 2d 762, 791–92 (S.D. Ohio 2001); aff'd 326 F.3d.737 (6th Cir. 2003).

[123] See, e.g., Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JSC–3–03) February, 2003 ("Enron Report"), Volume III at C–93, 289. Enron Corporation relied on Frank Lyon Co. v. United States, 435 U.S. 561, 577–78 (1978), and Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990), to argue that financial accounting benefits arising from tax savings constitute a good business purpose.

[124] See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997), cert. denied 526 U.S. 1017 (1999).

[125] See, e.g., TIFD–III–E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006).

devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. The Committee recognizes that IRS has achieved a number of recent successes in litigation. The Committee believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to assure such continued application of the doctrine and to improve its effectiveness at deterring unintended consequences. The Committee believes that a stronger penalty imposed on understatements attributable to non-economic substance transactions is desirable in this connection, to deter taxpayers from entering such transactions and thus improve compliance.

The Committee believes the same result with respect to interest on underpayments that occurs with respect to nondisclosed reportable transactions should also apply to noneconomic substance transactions.

EXPLANATION OF PROVISION

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-Federal-tax purpose for entering into such transaction. The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision. Thus, the provision does not change current law standards used by courts in determining when to utilize an economic substance analysis.[126]

The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among[127] these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;[128] (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a

[126] See, e.g., Treas. Reg. sec. 1.269–2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

[127] The examples are illustrative and not exclusive.

[128] See, e.g., John Kelley Co. v. Commissioner, 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).

foreign investment;[129] (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;[130] and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[131] Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[132] As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions can be a question of facts and circumstances. Also, the fact that a transaction does meet the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.[133]

The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax motivated benefits.[134]

Conjunctive analysis

The provision clarifies that the economic substance doctrine involves a conjunctive analysis—there must be a judicial inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer must

[129] See, e.g., Sam Siegel v. Commissioner, 45. T.C. 566 (1966), acq. 1966–2 C.B. 3; but see Commissioner v. Bollinger, 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under all the facts and circumstance).

[130] See, e.g. Rev. Proc. 2007–3 2007–1 I.R.B. 108, secs 3.01(33), (34), and (36) (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); compare Gregory v. Helvering. 293 U.S. 465 (1935).

[131] See, e.g., National Carbide v. Commissioner, 336 U.S. 422 (1949), Moline Properties v. Commissioner, 319 U.S. 435 (1943); compare, e.g. Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971), acq., 1972–2 C.B. 1; Commissioner v. Bollinger, 485 U.S. 340 (1988), see also sec. 7701(l).

[132] See, e.g., Frank Lyon v. Commissioner, 435 U.S. 561 (1978); Hilton v. Commissioner, 74 T.C. 305, aff'd 671 F. 2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982); Coltec Industries v. United States, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied 127 S. Ct. 1261 (Mem) (2007).

[133] As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the Code, or does not have economic substance, see e.g., TIFD–III–E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006); BB&T Corporation v. United States, ——F. Supp.——, 2007–1 USTC P 50,130 (M.D.N,C, 2007); Tribune Company and Subsidiaries v. Commissioner, 125 T.C. 110 (2005) ; H.J. Heinz Company and Subsidiaries v. United States, 76 Fed. Cl. 570 (2007); Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied 127 S. Ct. 1261 (Mem.) (2007); Long Term Capital Holdings LP v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd 150 Fed. Appx. 40 (2d Cir. 2005); Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Texas 2007); Santa Monica Pictures LLC v. Commissioner, 89 T.C.M. 1157 (2005).

[134] See, e.g., Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied 127 S. Ct. 1261 (Mem.) (2007) ("the first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities.. . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale...") 454 F.3d 1340, 1358 (Fed. Cir. 2006). See also ACM Partnership v. Commissioner, 157 F.3d at 256 n.48; Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

have a substantial non-Federal-tax purpose[135] for entering into such transaction, in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-Federal-tax business purpose

Under the provision, a taxpayer's non-Federal-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial."[136]

An objective of achieving a favorable accounting treatment for financial reporting purposes will not itself be treated as a substantial non-Federal-tax purpose if the origin of such financial accounting benefit is a reduction of Federal income tax.[137] For example, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[138] should not be considered to have a substantial non-Federal-tax purpose unless a substantial non-Federal-tax purpose exists apart from the financial accounting benefits.[139]

Profit potential

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-tax purpose for entering into such transaction. The provision does not require or establish a specified minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, the present

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[135] A purpose of reducing non-Federal taxes is not a non-Federal-tax business purpose if (i) the transaction will effect a reduction in both Federal and non-Federal taxes because of similarities between Federal tax law and the law of the other jurisdiction and (ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non-Federal taxes.

[136] See, e.g., Treas. Reg. sec. 1.269–2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189 (1997), the court stated: "Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs." [citations omitted]

[137] However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

[138] This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

[139] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., American Electric Power, Inc. v. United States, 136 F. Supp. 2d 762, 791–92 (S.D. Ohio 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'") (citing Winn-Dixie v. Commissioner, 113 T.C. 254, 287 (1999)); aff'd, 326 F3d 737 (6th Cir. 2003).

value of the reasonably expected pre-Federal-tax profit must be substantial in relation to the present value of the expected net Federal tax benefits that would be allowed if the transaction were respected.[140] In addition, in determining pre-Federal-tax profit, foreign taxes are treated as expenses to the extent provided in regulations.[141]

Other rules

The Secretary may prescribe regulations that provide (1) exemptions from the application of the provision, and (2) other rules as may be necessary or appropriate to carry out the purposes of the provision.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, the provision shall not be construed as altering or supplanting any other common law doctrine or provision of the Code or regulations or other guidance thereunder; and the provision shall be construed as being additive to any such other doctrine, Code provision, or regulations or guidance thereunder.

EFFECTIVE DATE

The provision applies to transactions entered into after the date of enactment.

2. Penalty for understatements attributable to transactions lacking economic substance, etc.

PRESENT LAW

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[142] Except in the case of tax shelters,[143] the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may

[140] Thus, a "reasonable possibility of profit" alone will not be sufficient to establish that a transacgtion has economic substance.

[141] There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law. However, the Treasury Department may, in addition, choose to require treatment of foreign taxes as expenses as provided in regulations.

[142] Sec. 6662.

[143] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[144] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[145]

Listed Transactions and Reportable Avoidance Transactions

In general

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Both listed transactions and reportable transactions are allowed to be described by the Treasury Department under section 6707A(c), which imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[146] A listed transaction is defined as a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[147]

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[148] The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a

[144] Sec. 6664(c).
[145] Treas. Reg. sec. 1.6662–4(g)(4)(i)(B); Treas. Reg. sec. 1.6664–4(c).
[146] Sec. 6707A(c)(1).
[147] Sec. 6707A(c)(2).
[148] Sec. 6662A(a).

strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[149] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[150] The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[151]

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[152]

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);[153] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.[154]

Strengthened reasonable cause exception

A penalty is not imposed with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction

[149] Sec. 6662A(c).
[150] Sec. 6664(d).
[151] Sec. 6707A(d).
[152] Sec. 6707A(e).
[153] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income. Sec. 6662A(b).
[154] Sec. 6662A(e)(3).

in accordance with the regulations under section 6011;[155] (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.[156]

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor" or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor[157] and who participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates; (2) is compensated directly or indirectly[158] by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state, or local government body.[159] Participation in the "management" of a transaction means involvement in the decision-making process regarding any

[155] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

[156] Sec. 6664(d).

[157] The term "material advisor" means any person who provides any material aid, asistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case). Sec. 6111(b)(1).

[158] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[159] An advisor shoud not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion, or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

To the extent a penalty on an understatement is imposed under section 6662A, that same amount of understatement is not also subject to the accuracy-related penalty under section 6662(a) or to the valuation misstatement penalties under section 6662(e) or 6662(h). However, such amount of understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1) and for purposes of identifying an underpayment under the section 6663 fraud penalty.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

EXPLANATION OF PROVISION

The provision imposes a new, stronger penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "noneconomic substance transaction understatement").[160] The penalty rate is 30 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty are available (i.e., the penalty is a strict-liability penalty). Under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or is not respected as described below.

A "noneconomic substance transaction" means any transaction if the transaction lacks economic substance (as defined in the provision regarding the clarification of the economic substance doctrine).[161] For this purpose, a transaction is one that lacks economic

[160] Thus, unlike the present-law accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under the provision applies to any transaction that lacks economic substance.

[161] That provision generally provides that in any case in which a court determines that the economic substance doctrine is relevant, a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial non-Federal-tax purpose for entering

Continued

substance if it is disregarded as a result of the application of the same factors and analysis that is required under the provision for an economic substance analysis, even if a court uses a different term to describe the doctrine.

For purposes of the bill, the calculation of an "understatement" is made in the same manner as in the present law provision relating to accuracy-related penalties for listed and reportable avoidance transactions (sec. 6662A). Thus, the amount of the understatement under the provision would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[162] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

As in the case of the understatement penalty for reportable and listed transactions under present law section 6662A(e)(3), except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

As in the case of the understatement penalty for undisclosed reportable transactions under present law section 6707A, a public entity that is required to pay a penalty under the provision (but in this case, regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Regardless of whether the transaction was disclosed, a penalty under the provision cannot be asserted until there has been a review and approval by the Chief Counsel of the Internal Revenue Service (or, if so delegated, a branch chief within the office of Chief Counsel) and the taxpayer has had the opportunity to submit a written statement in connection with that review. Once the penalty has been asserted following such National Office review, the penalty cannot be compromised for purposes of a settlement without approval of the Chief Counsel (or, if so delegated, a branch chief within the office of Chief Counsel). The penalty can be compromised in such event only to the extent the underlying under-

into such transaction. Specific other rules also apply. See "Explanation of Provision" for the immediately preceding provision, "Clarification of the economic substance doctrine."

[162] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

statement with respect to which it was asserted is also compromised. Furthermore, the IRS is required to keep records summarizing the application of this penalty and providing a description of each penalty compromised under the provision and the reasons for the compromise. If a final adjudication of a court determines that the economic substance doctrine does not apply, then a noneconomic substance penalty asserted by the IRS in that case would not apply.

Any understatement on which a penalty is imposed under the provision will not be subject to the accuracy-related penalty under section 6662 or under 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under the provision is taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under the provision will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.[163]

EFFECTIVE DATE

The provision applies to transactions entered into after the date of enactment.

3. Denial of deduction for interest on underpayments attributable to noneconomic substance transactions

PRESENT LAW

No deduction for interest is allowed for interest paid or accrued on any underpayment of tax which is attributable to the portion of any reportable transaction understatement with respect to which the relevant facts were not adequately disclosed.[164] The Secretary of the Treasury is authorized to define reportable transactions for this purpose.[165]

DESCRIPTION OF PROPOSAL

The provision extends the disallowance of interest deductions to interest paid or accrued on any underpayment of tax which is attributable to any noneconomic substance underpayment (whether or not disclosed).

EFFECTIVE DATE

The provision applies to transactions entered into after the date of enactment

[163] Nothing in the provision precludes the IRS from asserting alternative grounds in a case in addition to a lack of economic substance or from asserting other penalties; however, at the conclusion of the case if there is a penalty under this provision then the interaction with any other penalties would be as described in the text.

[164] Sec. 162(m). Under section 6664(d)(2)(A), in such a case of nondisclosure, the taxpayer also is not entitled to the "reasonable cause and good faith" exception to the section 6662A penalty for a reportable transaction understatement.

[165] See the description of present law under the immediately preceding proposal, "Penalty for understatements attributable to transactions lacking economic substance, etc."

III. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the revenue provisions of the "Heartland, Habitat, Harvest, and Work Horticulture Act of 2007" as reported.

ESTIMATED BUDGET EFFECTS OF
THE "HEARTLAND, HABITAT, HARVEST AND HORTICULTURE ACT OF 2007,"
AS REPORTED BY THE COMMITTEE ON FINANCE

Fiscal Years 2008 - 2017

[Millions of Dollars]

Provision	Effective	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
I. Supplemental Agricultural Disaster Assistance from the Agricultural Disaster Relief Trust Fund (the authority provided by the provision expires at the same time as the 2007 Farm Bill) [1] [2] [3]	**DOE**	**-693**	**-998**	**-1,074**	**-1,137**	**-1,198**	**---**	**---**	**---**	**---**	**---**	**-5,100**	**-5,100**
II. Conservation Provisions													
1. Provide tax credit for eligible farmland enrolled in Conservation Reserve Program [4] [5] [6] [7]	tyba DOE	---	-935	-937	-949	-950	---	---	---	---	---	-3,771	-3,771
2. Exclusion of Conservation Reserve Program Payments from SECA tax for individuals receiving Social Security retirement or disability benefits [7]	pma 12/31/07	[8]	-21	-22	-22	-22	-23	-24	-24	-24	-24	-87	-206
3. Make permanent the special rule for contributions of qualified conservation contributions	cmi tyba 12/31/07	-36	-46	-57	-69	-83	-86	-90	-94	-98	-102	-291	-761
4. Provide a tax credit for recovery and restoration of endangered species	tyba 12/31/07	-13	-79	-122	-201	-250	-262	-202	-135	-67	-33	-665	-1,364
5. Deduction for endangered species recovery expenditures	epoia DOE	-14	-21	-24	-29	-35	-40	-47	-54	-63	-73	-122	-399

Provision	Effective	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
6. Provide an exclusion for certain payments and programs relating to fish, wildlife, forest protection and pest management	pra DOE	-4	-7	-7	-7	-7	-7	-7	-7	-7	-7	-32	-69
7. Provide an option to elect tax credits in lieu of payments under conservation programs:													
a. Wetlands Reserve Program	[9]	*Negligible Revenue Effect*											
b. Working Grasslands Program	[9]	-15	-15	-15	-15	-15	---	---	---	---	---	-75	-75
8. Provide for exempt facility bonds for forest conservation activities	[10]	-3	-10	-19	-27	-32	-33	-33	-33	-33	-33	-92	-257
9. Deduction for qualified timber gain and timber REIT provisions (sunset one year after the date of enactment)	tyba DOE	-173	-102	-17	-14	-12	-6	-2	-2	-2	-2	-318	-332
Total of Conservation Provisions		**-258**	**-1,236**	**-1,220**	**-1,333**	**-1,406**	**-457**	**-405**	**-349**	**-294**	**-274**	**-5,453**	**-7,234**
III. Energy Provisions													
1. Credit for wind property - provide 30% credit, capped at $4,000, for residential and commercial applications of small wind (sunset 12/31/08)	ea 12/31/07	-2	-3	[8]	[8]	[8]	[11]	[11]	---	---	---	-5	-5
2. Landowner incentive to encourage electric transmission build-out of section 45 facilities (exclusion applies only to payments received related to transmission lines and equipment used to transmit electricity at 230 or more kilovolts)	pra DOE	-5	-16	-17	-18	-18	-19	-20	-21	-23	-23	-74	-179
3. Modify treatment of certain USDA energy grants/loans used for renewable power facilities	fpisa DOE	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-6	-14
4. Expansion of special depreciation allowance for cellulosic biomass ethanol plant property	[12]	---	-1	-1	-1	-2	---	1	1	1	1	-4	-1
5. Small producer credit for up to 60 million gallons of cellulosic alcohol fuel production (sunset 4/1/15)	apa 12/31/07	---	-2	-24	-94	-162	-243	-339	-208	-6	---	-282	-1,079

Provision	Effective	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
6. Extend for two years the small ethanol producer credit (sunset 12/31/12)...................	DOE	---	---	---	-15	-43	-41	-28	-30	-15	---	-57	-172
7. 25 cent small producer credit for fossil-free producers of alcohol (sunset 12/31/12)...........	apa 12/31/07	-9	-18	-35	-70	-110	-36	---	---	---	---	-242	-278
8. Modification of the incentives relating to alcohol fuels (VEETC)..................................	DOE	---	294	438	121	---	---	---	---	---	---	854	854
9. Exclude volume of denaturants from the alcohol fuels credit...	fsoua 12/31/07	59	91	102	32	---	---	---	---	---	---	284	284
10. Extension of temporary duty on ethyl alcohol through 12/31/10 [1] [13]...............................	DOE	---	9	13	3	---	---	---	---	---	---	25	25
11. Elimination of certain refunds of duty imposed on ethanol [1]..................................	[14]	6	1	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	8	10
12. Extend for two years the $1.00 and 50 cent production credits for biodiesel (sunset 12/31/10) and extend for four years the 10 cent credit for small agri-biodiesel producers (sunset 12/31/12), add camelina to the nonexclusive list of sources for agri-biodiesel.	DOE	---	-84	-128	-42	-10	-3	---	---	---	---	-264	-267
13. Extension and modification of renewable diesel incentives (sunset 12/31/10).................	DOE & fsoua DOE	25	-59	-132	-44	---	---	---	---	---	---	-211	-211
14. Treatment of qualified fuel mixtures as taxable fuel with additional reporting requirements..	freosa 12/31/07	4	1	1	1	1	-6	---	---	---	---	8	2
15. Extension and modification of alternative fuels excise tax credit, including CTL, and additional CO2 sequestration for CTL (sunset 12/31/10 for non-hydrogen fuels)	DOE & fsoua DOE	[8]	[8]	-267	-65	---	---	---	---	---	---	-332	-332
16. Extension of credit for installation of alternative fuel refueling property (sunset 2010 for non-hydrogen refueling property).....	DOE	---	---	-49	-42	-15	-11	-7	[8]	2	2	-107	-119
Total of Energy Provisions		**77**	**212**	**-100**	**-235**	**-360**	**-360**	**-394**	**-259**	**-42**	**-21**	**-405**	**-1,482**

Provision	Effective	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
IV. Agricultural Provisions													
1. Qualified small issue bonds for farming - increase loan limit from $250,000 to $450,000 and index; and eliminate the dollar limitation in definition of substantial farmer....	bia DOE	[8]	[8]	-1	-1	-2	-2	-3	-3	-4	-4	-4	-19
2. Modification of installment sale rules for certain farm property......................................	sa DOE	-8	-31	-30	-29	-28	-27	-25	-24	-23	-22	-125	-246
3. Allowance of section 1031 treatment for exchanges involving certain mutual ditch, reservoir, or irrigation company stock............	eca DOE	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	[8]	-1	-2
4. Credit to holders of rural renaissance tax credit bonds..	bia DOE & bio/b 12/31/08	-6	-18	-23	-22	-20	-19	-17	-16	-14	-13	-89	-168
5. Agricultural business security tax credit.........	DOE	-2	-3	-3	-3	-3	-1	[11]	[11]	[11]	[11]	-14	-14
6. Credit for drug safety and effectiveness testing for minor species	eia DOE	-1	-5	-9	-12	-13	-15	-15	-16	-16	-17	-41	-121
7. Reduce the recovery period for certain farming business machinery or equipment from seven to five years (sunset 12/31/09)......	ppisa DOE	-160	-327	-383	-320	-287	-62	415	652	390	82	-1,477	[15]
8. Expensing of broadband internet access expenditures (sunset 12/31/10).......................	eia DOE	-117	-175	-234	28	98	76	67	62	64	58	-399	-72
9. Provide a tax credit for purchase of qualified energy efficient motors that meet or exceed energy standards (sunset 36 months after date of enactment)..	eempisa DOE	-17	-33	-44	-27	-11	-6	-1	4	4	2	-132	-129
Total of Agricultural Provisions		**-311**	**-592**	**-727**	**-386**	**-266**	**-56**	**421**	**659**	**401**	**86**	**-2,282**	**-771**
V. Revenue Raising Provisions													
A. Miscellaneous Revenue Provisions													
1. Limitation on farming losses of certain taxpayers...	tyba 12/31/07	40	64	60	59	56	51	44	35	27	19	279	456
2. Increase and index dollar threshold for farm optional method and nonfarm optional method for computing net earnings from self-employment [7]..	tyba 12/31/07	5	10	10	11	11	11	12	13	13	14	46	110

Provision	Effective	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
3. Information reporting for Commodity Credit Corporation transactions	lro/a 1/1/07						No Revenue Effect						
4. Modification of section 1031 treatment for certain real estate	eca DOE	3	3	2	2	2	2	3	3	3	3	12	27
5. Modify the effective date for the application of the AJCA 2004 leasing (SILO) provision - apply loss limitation to leases with foreign entities regardless of when the lease was entered into	tyba 12/31/06	2,680	896	407	290	288	260	135	-239	-629	-854	4,561	3,235
6. Increase by 7.00 Percentage Points the Required Corporate Estimated Tax Payments Factor for Corporations with Assets of at Least $1 Billion for Payments Due in July, August, and September 2012	DOE	---	---	---	---	4,336	-4,336	---	---	---	---	4,336	---
7. Ineligibility of collectibles for nontaxable like kind exchange treatment	eca DOE	3	20	20	20	17	18	19	19	20	20	79	175
8. Denial of deduction for certain fines, penalties, and other amounts	generally apoio/a DOE	62	31	15	15	15	15	15	15	15	15	137	210
9. Increase information return penalties	irrtbfo/a 1/1/08	---	---	35	85	83	82	81	81	79	78	202	603
B. Economic Substance Doctrine													
1. Clarification of economic substance and related penalties	teia DOE	397	645	755	870	1,017	1,189	1,231	1,260	1,300	1,348	3,684	10,012
2. Denial of deduction for interest paid on certain tax motivated transactions	teia DOE	---	---	1	3	4	5	6	7	8	9	8	43
Total of Revenue Raising Provisions		**3,190**	**1,669**	**1,305**	**1,355**	**5,829**	**-2,703**	**1,546**	**1,194**	**836**	**652**	**13,344**	**14,871**
NET TOTAL		**2,005**	**-945**	**-1,816**	**-1,737**	**2,599**	**-3,576**	**1,168**	**1,245**	**901**	**443**	**104**	**284**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. The date of enactment is assumed to be December 1, 2007.

[Legend and Footnotes for the Table appear on the following page]

Legend and Footnotes for the Table:

Legend for "Effective" column:

- apa = alcohol produced after
- apoio/a = amounts paid or incurred on or after
- bia = bonds issued after
- bio/b = bonds issued on or before
- cmi = contributions made in
- DOE = date of enactment
- ea = expenditures after
- eca = exchanges completed after
- eempisa = energy efficient motors placed in service after
- eia = expenses incurred after
- epoia = expenditures paid or incurred after
- fpisa = facilities placed in service after
- freosa= fuels removed, entered, or sold after
- fsoua = fuel sold or used after
- irrtbfo/a = information returns required to be filed on or after
- lro/a = loans repaid on or after
- pma = payments made after
- ppisa = property placed in service after
- pra = payments received after
- sa = sales after
- spa = services performed after
- teia = transactions entered into after
- tyba = taxable years beginning after

[1] Estimate provided by the Congressional Budget Office and is preliminary and subject to change.

[2] Reduction in funds available to the general fund of the U.S. Government. The proposal will also result in an increase in outlays of the following amounts..

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
	868	988	1,030	1,043	1,055	81	---	---	---	---	4,982	5,064

[3] Estimate provided by the Congressional Budget Office and includes clarification of the definition of farm-raised fish to include the propagation and rearing of aquatic species in controlled or selected environments and the expansion of the definition of livestock to include horses. The Congressional Budget Office also estimates that the provision will have a negligible effect on outlays.

[4] Tax credits would be excludable from income for income and SECA tax purposes.

[5] The proposal will also result in a decrease in outlays of the following amounts...

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-12	2008-17
	---	750	750	750	750	---	---	---	---	---	3,000	3,000

[6] Estimate includes a reduction in SECA taxes of $425 million over the fiscal years 2008 through 2012.

[7] Revenue estimate does not include any resulting effects on Social Security and Medicare outlays. These will be estimated by the Congressional Budget Office.

[8] Loss of less than $500,000.

[9] Effective for easements granted after September 30, 2007, in taxable years ending after such date.

[10] Effective for obligations issued on or after the date which is 180 days after the enactment of this Act.

[11] Gain of less than $500,000.

[12] Effective for property placed in service after the date of enactment in taxable years ending after the date of enactment.

[13] The estimate contains interaction with the provision to eliminate certain refunds of duty imposed on ethanol.

[14] Effective for goods exported on or after the date that is 15 days after the date of enactment.

[15] Negligible revenue effect

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the supplemental agricultural disaster assistance provisions of the bill as reported involve new or increased budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in Part A., above). The revenue-increasing provisions of the bill involve reduced tax expenditures (see revenue table in part A, above).

C. Consultation With Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has not submitted a statement on the bill. The letter from the Congressional Budget Office has not been received, and therefore will be provided separately.

IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the Committee states that, with a majority and quorum present, the "Heartland, Habitat, Harvest and Work Horticulture Act of 2007," as amended, was ordered favorably reported by a voice vote on October 4, 2007.

V. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

Impact on individuals and businesses, personal privacy and paperwork

The bill includes provisions to extend present-law tax benefits, expand eligibility for other benefits, and create new tax incentives. The bill also includes provisions limiting farming losses of certain taxpayers, codifying information reporting on Commodity Credit Corporation transactions and limiting section 1031 treatment for certain real estate and collectibles. The effective date of AJCA relating to loss limitations on SILOs is also modified under the bill. The bill also denies a deduction for certain fines, penalties and other amounts and increases information return penalties. Finally, the bill includes provisions to clarify and codify the economic substance doctrine and related penalties and to deny the deduction for interest paid on certain tax motivated transactions.

The bill includes various other provisions that are not expected to impose additional administrative requirements or regulatory burdens on individuals or businesses.

The provisions of the bill do not impact personal privacy.

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4).

The Committee has determined that the following two tax provisions of the reported bill contain Federal private sector mandates within the meaning of Public Law 104–4, the Unfunded Mandates Reform Act of 1995: (1) modifying the effective date for the application of the AJCA 2004 leasing ("SILO") provision—apply loss limitation to leases with foreign entities regardless of when the lease was entered into; and (2) clarification of the economic substance doctrine and related penalties. The tax provisions of the reported bill do not impose a Federal intergovernmental mandate on State, local, or tribal governments within the meaning of Public Law 104–4, the Unfunded Mandates Reform Act of 1995.

The costs required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision. Benefits from the provisions include improved administration of the tax laws and a more accurate measurement of income for Federal income tax purposes.

C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that have "widespread applicability" to individuals or small businesses.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

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