DRAFT 2005-LYxz-284: IRC Update

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	February 8, 2006
Introduced by:		**Summary by:**	Y. Canaan Huie
Version:	Draft 2005-LYxz-284		Committee Counsel

SUMMARY: This bill would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. In addition the bill would shorten the time span in which a taxpayer would have to file an amended estate, income, or gift tax return when the federal government corrects or otherwise determines the amount on which the tax is based. The bill also conforms the filing date for income tax returns for a nonresident alien to the federal dates. Finally, the bill would conform the amounts for the credit for child care and certain employment-related expenses to the amounts allowed for the corresponding federal credit.

CURRENT LAW: Currently the reference date for the Internal Revenue Code is January 1, 2005.

When the federal government corrects or otherwise determines the amount on which an estate, income, or gift tax is based, the taxpayer must file a State return within 2 years that reflects that change.

Nonresidents aliens are currently required to file State income tax returns before their federal returns are due.

Currently, the credit for child care and certain employment-related expenses may not be based on expenses in excess of $2,400 if the household includes one qualifying individual or $4,800 if the household includes more than one qualifying individual.

BILL ANALYSIS:

IRC Update

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[2] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. This bill would change the reference date from January 1, 2005, to January 1, 2006, effective when the bill become law.

[1] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

Between January 1, 2005, and January 1, 2006, there were four major pieces of federal legislation that made changes to the Internal Revenue Code. This federal legislation includes the Energy Tax Incentive Act of 2005 (P.L. 109-58) signed into law on August 8, 2005, the SAFE Transportation Equity Act of 2005 (P.L. 109-59) signed into law on August 10, 2005, the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) signed into law on September 23, 2005, and the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) signed into law on December 21, 2005.

Energy Tax Incentive Act of 2005 (P.L. 109-58) (hereinafter Energy Act)

Many of the changes made in this act involve tax credits for various activities. Because they are tax credits, these provisions do not have a direct impact at the State level. There are, however, several provisions that could have an impact at the State level, most of which involve the depreciation, amortization, or expensing of certain items.

- *Elimination of deduction for clean-fuel vehicles.* Under previous law, a taxpayer was allowed a deduction for the purchase of a qualified clean-fuel vehicle. A "qualified clean-fuel vehicle" is any motor vehicle that may be propelled by a clean-burning fuel such as natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, or any other fuel at least 85% of which is methanol, ethanol, or other alcohol or ether. The maximum amount of the deduction varied depending on the type of vehicle purchased. The deduction began to be phased out in 2004, and was set to be eliminated after the 2006 taxable year. This act moves up the phase-out so that the deduction is eliminated after the 2005 taxable year. In place of the deduction, this act creates a new federal credit for alternative fuel motor vehicles.

- *Tax deferral for gains on electric transmission assets.* Under current law, a taxpayer may elect to recognize qualified gain from a qualifying electric transmission transaction over an eight-year period. In order for a transaction to be a "qualifying electric transmission transaction" numerous conditions must be satisfied, one of which is that the transaction must be completed before January 1, 2007. This act extends that date by one year to January 1, 2008.

- *Deduction for nuclear decommissioning costs.* Utilities that own or operate a nuclear power plant are required by law to decommission the plant at the end of its useful life. A utility may elect to deduct contributions it makes to a nuclear decommissioning reserve fund established to help pay the costs associated with the eventual decommissioning. For previous tax years, contributions to such a reserve fund were limited to the lesser of the amount of nuclear decommission costs allocable to the fund that is included in the taxpayer's cost of services for ratemaking purposes for the taxable year and the ruling amount. The "ruling amount" is a schedule obtained from the IRS that specifies the annual payments that must be made into the fund to cover of the amount of the decommission costs allocable to the fund over its existence. This act eliminates the "lesser of" test for taxable years beginning on or after January 1, 2006, and instead limits the deduction to the ruling amount.

- *Energy efficient commercial buildings property deduction.* Despite the fact that large commercial buildings use approximately one-fourth of the electrical energy consumed in the nation, there is currently no federal tax incentive to encourage the use of energy-efficient property in the construction or renovation of commercial buildings. This act allows taxpayers to claim a deduction (as opposed to depreciation or amortization) with respect to costs associated with energy-efficient commercial building property placed into service

between January 1, 2006, and January 1, 2008. The maximum amount that may be deducted is $1.80 per square foot of the building, less any amount deducted under this provision with respect to the same building in previous tax years. In order to qualify for the deduction, the following conditions must be satisfied: 1) The costs must be associated with depreciable or amortizable property that is installed in a commercial building that meets certain standards for energy efficiency; 2) The property is installed as part of the interior lighting, heating, cooling, ventilation, or hot water systems or the building envelope; and 3) The property is installed as part of a plan to reduce the total annual energy costs of the building with respect to the interior lighting, heating, cooling, ventilation, and hot water systems by at least 50% as compared to a similar building that meets certain minimum standards for energy efficiency. The IRS is required to issue regulations relating to eligibility for a partial deduction and to the transfer of a deduction from a public entity (like the State) to the person responsible for designing the property.

- *Recapture of section 197 amortization.* Generally, property subject to amortization under section 197 of the Code is intangible property that is purchased and held by a taxpayer in the course of a business. Section 197 property includes goodwill, covenants not to compete, patents, copyrights, trademarks and certain licenses. The cost of section 197 property is recoverable over fifteen years using straight-line depreciation. Under general rules, gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed. Under general rules, the recapture amount is computed separately for each piece of property. This act provides that if multiple pieces of section 197 property are sold or disposed of in a single transaction or series of transactions, then the taxpayer must compute the recapture as if all of the property were a single asset. The effect of this change is to maximize the amount of income treated as recapture, and thus as ordinary income, and the lessen the amount treated as a capital gain, which is taxed at a lower rate.

- *Depreciation of electric transmission property.* Generally, under the modified accelerated cost recovery system (MACRS) assets used in the transmission and distribution of electricity for sale have a 20-year recovery period. This act allows the costs of certain electric transmission property placed into service after April 11, 2005, to be recovered over 15 years instead of 20.

- *Expensing liquid fuel refineries.* Under previous law, petroleum refining assets were depreciated over a 10-year recovery period using the double declining balance method. Petroleum refining assets are assets used for distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and other petroleum products. This acts allows a taxpayer to make an election to expense 50% of the cost of qualified refinery property in the year in which the property is placed into service. "Qualified refinery property" includes any portion of a qualified refinery that satisfies the following conditions: 1) The original use of the property commences with the taxpayer; 2) The property is placed in service between August 8, 2005, and January 1, 2012; 3) The property satisfies certain production capacity requirements; 4) The property satisfies all applicable environmental laws in effect when it is placed into service; 5) No written binding contract for the construction of the property was in effect on or before June 14, 2005; and 6) The construction of the property is subject to a written binding contract entered into before January 1, 2008. A "qualified refinery" is one that is located in the United States and that is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels (including shale and tar sands and coal

seams). The expensing election is not available with respect to a refinery that is used primarily as a topping plant, asphalt plant, lube oil facility, crude or product terminal, or blending facility.

- *Depreciation of natural gas distribution lines.* Under previous law, natural gas distribution lines installed by a gas company were depreciated over a 20-year period. This act allows natural gas depreciation lines placed in service between April 11, 2005, and January 1, 2011, to be depreciated over a 15-year period.
- *Depreciation of natural gas gathering pipelines.* Prior to the enactment of this act, there was a disagreement among the courts as to what asset class natural gas gathering pipelines owned by a nonproducer belonged. The IRS maintained, and this position was supported by the Tax Court, that these pipelines belonged to an asset class subject to depreciation over 15 years. The Courts of Appeals in the Sixth, Eighth, and Tenth Circuits, however, held that these pipelines belonged to an asset class subject to depreciation over 7 years. There was agreement that natural gas gathering pipelines owned by a producer were part of the asset class subject to depreciation over 7 years. This act clarifies that all natural gas gathering pipelines, regardless of ownership, are subject to depreciation over 7 years. This provision applies to natural gas gathering pipelines placed in service after April 11, 2005.
- *Geological and geophysical costs amortized over two years.* Geological and geophysical costs are those incurred for the purpose of accumulating data that serves as the basis for the decision about acquisition or retention of mineral rights by taxpayers in the business of exploring for minerals (including gas and oil). Courts have held these costs to be capital in nature and allocable to the property acquired or retained. If no property was acquired or retained, the costs were treated as a capital loss. This act provides that these costs, when incurred in the United States for oil or gas exploration, shall be amortized ratably over a 24-month period beginning on the mid-point of the taxable year in which the costs were incurred. The act does not affect the treatment of costs incurred outside of the United States or with respect to exploration for minerals other than oil or gas.
- *84-month amortization of air pollution control facilities.* Current law allows taxpayers to amortize a certified pollution control facility used in connection with a plant that was in operation before January 1, 1976, over a 60-month period. For certified pollution control facilities placed in service after April 11, 2005, this act eliminates the requirement that the property be used in connection with a plant that was in operation before 1976 if the plant is an electric generation plant that is primarily coal fired. For property that satisfies this criteria, the amortization period is 84-months. The act does not lengthen the amortization period for property that was covered by previous law, it provides a favored, though not as generously favored, method of depreciation for another class of property.

Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (P.L. 109-59) (hereinafter SAFE Act)

Although this act makes numerous tax changes at the federal level, these changes have little to no direct impact at the State level

Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) (hereinafter Katrina Act)

2005 was a record-setting year on the meteorological front. Not only did the year see a record number of named storms (27) and a record number of hurricanes (14), the year also included the costliest Atlantic hurricane on record and one of the deadliest, Hurricane Katrina. Hurricane Katrina made

landfall along the Gulf Coast on August 29, 2005, as a Category 4 storm. Hurricane Katrina resulted in the deaths of more than 1,400 people and caused over $80 billion in property damage.

In the aftermath of Hurricane Katrina, Congress took action to assist taxpayers in the affected region. On September 21, 2005, Congress passed the Katrina Emergency Tax Relief Act of 2005, which was signed into law by President Bush on September 23, 2005. The act is collection of tax relief provisions for individuals and businesses. Below, the key provisions of this act that could have an impact on State revenues are summarized.

General Provisions. The act contains definitions of several key phrases that are used throughout the act. Under the act, "Hurricane Katrina disaster area" means an area with respect to which a major disaster has been declared by the President before September 14, 2005, with respect to Hurricane Katrina. The states of Alabama, Florida, Louisiana, and Mississippi comprise the Hurricane Katrina disaster area. The act also defines the term "core disaster area." The core disaster area is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government. The core disaster area covers certain counties and parishes in Alabama, Louisiana, and Mississippi.

Retirement Funds. The act contains a number of special rules related to retirement funds for people who lived in the Hurricane Katrina disaster area or the core disaster area. Generally, these provisions allow for a more liberal use of retirement funds for emergency needs than would otherwise be allowed without subjecting the taxpayer to some sort of penalty or disincentive. These provisions include the following:

- *Tax favored withdrawals from retirement plans for relief relating to Hurricane Katrina.* Generally, a withdrawal from a qualified retirement plan, a tax-sheltered annuity, an IRA, or an eligible deferred compensation plan maintained by a state or local government is included in taxable income in the year in which it is made. In addition, a distribution that is received before death, disability, or the age of 59 ½ is generally subject to a 10% early withdrawal tax. Some distributions are known as eligible rollover distributions and are not included in taxable income or subject to the 10% penalty tax. These distributions must be rolled over into another qualified retirement account within 60 days.

  This act provides an exception to the 10% early withdrawal tax in the case of a qualified Hurricane Katrina distribution[3] from a qualified retirement plan, tax-sheltered annuity, or IRA. In addition, any amount required to be included in income as a result of a qualified Hurricane Katrina distribution is included in income in installments over the three-year period beginning with the year in which the distribution is made rather than entirely within the year that the distribution is made. Finally, any amount of a qualified Hurricane Katrina distribution that is recontributed to an eligible retirement account within the three-year period is treated as a roll-over distribution and is not included in income.

- *Recontribution of withdrawals for home purchases cancelled due to Hurricane Katrina.* There is an exception to the 10% early withdrawal tax discussed above in the case of a qualified first-time homebuyer distribution from an eligible retirement account. A qualified first-time homebuyer distribution is one that does not exceed $10,000 and that is used within 120 days of the distribution for the purchase or construction of a principal residence of a

[3] A "qualified Hurricane Katrina distribution" is a distribution made from an eligible retirement plan on or after August 25, 2005, and before January 1, 2007, to an individual whose primary place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss due to Hurricane Katrina. The total amount of qualified Hurricane Katrina distributions to a taxpayer from all accounts may not exceed $100,000.

first-time homebuyer. If the distribution is not used for the purchase of the home within 120 days or is not rolled over into an eligible retirement account within 60 days, the distribution is included in income and is subject to the 10% early withdrawal tax.

This act allows a taxpayer that received a qualified distribution from a retirement account to recontribute that amount to an eligible retirement account without penalty. For the purposes of this provision, a "qualified distribution" is a distribution that was received after February 28, 2005, and before August 29, 2005, and that was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed because of Hurricane Katrina. Any portion of a qualified distribution may be contributed to an eligible retirement account and treated as a roll-over if it is recontributed between August 25, 2005, and February 28, 2006. Because it is treated as a roll-over, that portion will not be included in income or subject to the 10% early withdrawal tax.

- *Loans from qualified plans for relief relating to Hurricane Katrina.* An individual is allowed to borrow from an qualified employer plan in which the individual participates provided the loan satisfies certain conditions. Generally, a loan from a qualified employer plan is treated as a taxable distribution of plan benefits. A loan is not treated as a tax distribution of benefits to the extent that the loan, when added to the outstanding balance of all other loans to the individual from all plans maintained by the employer, does not exceed the lesser of 1) $50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of $10,000 or one half the individual's accrued benefit under the plan. For this exception to apply, the loan must have a repayment period of five years or less, must be amortized in level payments, and must have payments due at least quarterly.

  This act provides special rules in the case of a loan from a qualified plan to a qualified individual. For the purposes of this provision, a "qualified individual" is one whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss because of Hurricane Katrina. Under this provision, the loan limit discussed above is increased to the lesser of 1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of $10,000 or the individual's accrued benefit under the plan.

  In addition, this act provides that in the case of a qualified individual with an outstanding loan from a qualified plan on or after August 25, 2005, if the due date for any repayment with respect to the loan occurs during the period from August 25, 2005, to December 31, 2006, the due date is delayed for one year.

Charitable Giving Incentives. In the wake of Hurricane Katrina, people from around the nation rushed to the aid of people in the affected areas with unprecedented amounts of charitable giving. As part of this act, Congress further encouraged and rewarded charitable giving.

- *Temporary suspension of limitations on charitable contributions.* In general, the income tax deduction allowed for charitable contributions is subject to limitations based on the type of taxpayer, the property contributed, and the donee organization. Subject to certain limitations, discussed further below, the following general rules apply: 1) Contributions of cash are

deductible in the amount contributed; 2) Contributions of capital gain property[4] to a qualified charity are deductible at fair market value; 3) Contributions of other appreciated property are deductible at the donor's basis in the property; and 4) Contributions of depreciated property are deductible at the fair market value of the property.

Most contributions are subject to percentage limitations. For individuals, the amount deductible is limited to a percentage of the taxpayer's contribution base[5]. The percentage varies depending on the type of donee organization and the type of property contributed. Contributions by an individual of property other than appreciated capital gain property to a charitable organization described in section 170(b)(1)(A) of the Code (public charities, private foundations other than private non-operating foundations, and certain governmental units) are deductible up to 50% of the contribution base. Contributions of this type of property to nonoperating private foundations and certain other organizations are deductible up to 30% of the contribution base. Contributions of appreciated capital gain property to an organization described in section 170(b)(1)(A) of the Code are generally deductible up to 30% of the contribution base. A taxpayer may elect to bring all of these contributions of appreciated capital gain property under the 50% limitation by reducing the amount of the deduction by the amount of the appreciation of the property. Contributions of appreciated capital gains property to a private nonoperating foundation are deductible up to 20% of the contribution base. For corporations, charitable contributions are deductible up to 10% of the corporations taxable income computed without regard to net operating loss or capital loss carrybacks. For both individuals and corporations, excess charitable contributions may be carried forward for up to five years.

There is also an overall limitation on most itemized deductions for individuals. The total amount of otherwise allowable itemized deductions is reduced by three percent of the amount of the taxpayer adjusted gross income in excess of a certain threshold. However, the otherwise allowed deductions may not be reduced by more than 80%. This reduction is reduced to two percent for the 2006 and 2007 taxable years and to one percent for the 2008 and 2009 taxable years, is repealed for the 2010 taxable year, and is reinstated for the 2011 taxable year.

This act provides several exceptions to the limitations on charitable contribution deductions. For individuals, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the taxpayer's deductions for other charitable contributions. In most cases, this means that an individual may deduct charitable contributions up to 100% of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. For corporations, the deduction for a qualified contribution is allowed up to amount by which the corporation's taxable income exceeds the deduction for other charitable contributions. For the purposes of these provisions, a "qualified contribution" is a cash contribution that is made between August 28, 2005, and December 31, 2005, to an organization described in section 170(b)(1)(A) of the Code. The term does not include a contribution of noncash property or one that is for the establishment or maintenance of a segregated fund or account with respect to which the donor reasonably expects to have advisory privileges with respect to the fund or account because of his status as donor. In the

[4] "Capital gain property" means any capital asset or property used in the taxpayer's trade or business the sale which at its fair market value, at the time of contribution, would have resulted in a gain that would have been a long-term capital gain.
[5] The "contribution base" is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

case of a corporation, the contribution must be for relief efforts related to Hurricane Katrina in order to be a qualified contribution.

In addition, for individuals the charitable deduction contribution, up to the amount of qualified contributions, is not treated as an itemized deduction and is not subject to the reduction for higher-income taxpayers.

- *Additional exemption for housing Hurricane Katrina displaced individuals.* In the aftermath of Hurricane Katrina, hundreds of thousands of residents of the affected areas were displaced. During this time of displacement, many individuals opened their homes to those who had been displaced. Generally, individuals are allowed personal exemptions in computing taxable income. Personal exemptions are allowed for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. Personal exemptions are phased out for higher-income taxpayers.

  This act allowed a taxpayer an additional $500 exemption for each Hurricane Katrina displaced individual of the taxpayer, up to a maximum additional exemption of $2,000. The additional exemption is not subject to the phase out for higher-income taxpayers. For the purposes of this provision, a "Hurricane Katrina displaced individual" is a person 1) whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area, 2) who was displaced from the abode, 3) who is provided housing free of charge in the taxpayer's principal place residence for a period of 60 consecutive days that ends in the taxable year in which the exemption is claimed, and 4) is not the spouse or dependent of the taxpayer. For a person whose principal place of abode on August 28, 2005, was outside of the core disaster area, the person's abode must have been damaged by Hurricane Katrina or the person must have been evacuated from the abode by reason of Hurricane Katrina.

- *Increase in standard mileage rate for charitable use of vehicles.* In determining the amount of the charitable contribution deduction when a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer may either deduct actual operating expenditures or use the charitable standard mileage rate. The charitable standard mileage rate, 14 cents per mile, is significantly less than the business standard mileage rate[6]. The charitable rate is less than the business rate because it is meant to offset direct operating expenses, such as gas, only and not other expenses, such as a depreciation, insurance, or general maintenance.

  This act allows a taxpayer who uses a vehicle in providing donated service to charity for Hurricane Katrina relief only to compute the charitable mileage deduction at a rate equal to 70% of the business standard mileage rate, rounded to the next highest cent, on the date of the contribution. In the alternative, the taxpayer may continue to use actual operating expenditures to determine the amount of the deduction.

- *Mileage reimbursement to charitable volunteers excluded from gross income.* Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent that the reimbursement exceeds deductible expenses computed using either direct expenses or the charitable standard mileage rate. Under this act, reimbursement for mileage expenses by a charitable organization described in section 170(c) of the Code to a volunteer for the costs of using a passenger vehicle for Hurricane Katrina relief only are not included in income to the

[6] For expenses incurred between January 1, 2005, and September 1, 2005, the standard business mileage rate was 40.5 cents per mile. For expenses incurred between September 1, 2005, and January 1, 2006, the standard business mileage rate was 48.5 cents per mile.

extent that the reimbursement does not exceed the amount that would be allowed using the business standard mileage rate. A taxpayer may not claim a deduction or credit for amounts excluded under this provision.

- *Charitable deduction for contribution of food inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

  This act allows the enhanced deduction to any taxpayer engaged in a trade or business that makes a donation of food inventory. For taxpayers other than C corporations, the total deduction for contributions of food inventory may not exceed 10% of the taxpayer's income from all business entities from which a contribution of food inventory is made. The enhanced deduction is available only for food that qualifies as "apparently wholesome food," – food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws even though the food may not be readily marketable for any number of reasons.

- *Charitable deduction for contribution of book inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

  This act extends the enhanced deduction for C corporations to qualified book contributions. A "qualified book contribution" is a charitable contribution of books to a public school that provides elementary education or secondary education and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils in attendance at the place where its education activities are regularly carried on.

Miscellaneous Provisions.

- *Exclusion for certain cancellations of indebtedness by reason of Hurricane Katrina.* Gross income includes income that is realized by a debtor for the discharge of indebtedness, subject to certain exceptions. This act provides that the gross income of a qualified individual does not include any amount which would otherwise by includible in gross income by reason of a

discharge of nonbusiness debt if the indebtedness is discharged by an applicable entity. The relief allowed under this provision does not apply to any indebtedness to the extent that real property outside of the Hurricane Katrina disaster area serves as security for the debts. For the purposes of this provision, a "qualified individual" is any natural person whose principal place of abode on August 25, 2005, was located 1) in the core disaster area or 2) in the Hurricane Katrina disaster area and the person suffered economic loss as a result of Hurricane Katrina. An "applicable entity" includes the following: a financial institution; a credit union; a corporation that is a direct or indirect subsidiary of a financial institution or credit union and as such is subject to regulation by federal or state agencies; the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, and certain other federal executive agencies; an executive, judicial, or legislative agency; and any other organization the for whom the lending of money is a significant trade or business.

- *Suspension of certain limitations on personal casualty losses.* A taxpayer may generally claim a deduction for any loss sustained during the taxable year for which he is not compensated by insurance or otherwise. For individuals, the loss must be incurred in a trade or business or consist of property loss attributable to casualty or theft. Losses are deductible only if they exceed $100 per casualty or theft and total casualty and theft losses exceed 10% of the taxpayer's adjusted gross income. This act removes the $100 and 10% limitations on casualty and theft losses to the extent those losses are in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina.

- *Required exercise of IRS administrative authority.* In general, the Secretary of the Treasury may grant reasonable extensions of time to taxpayers to perform certain acts. In addition, for certain military personnel, the time period for performing certain acts (such as filing returns, paying taxes, bringing suit) is automatically suspended. In the case of a Presidentially declared disaster or terroristic or military action, the Secretary has the authority to prescribe a period of up to one year in which the time period for the same actions is suspended. This act requires the Secretary to suspend those time periods at least until February 28, 2006, for taxpayers determined to have been affected by the Presidentially declared disaster relating to Hurricane Katrina. In addition, this act adds employment and excise taxes to the list of taxes for which the Secretary may extend filing and payment time periods.

- *Special rules for mortgage revenue bonds.* A qualified mortgage bond is a type of private activity bonds for which interest is excluded from gross income. Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences and to finance qualified home improvement loans. There are several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations, and a the requirement that the mortgagor be a "first-time homebuyer" – one that did not have any ownership interest in a primary residence for the previous three years. The first-time home buyer requirement does not apply to targeted area residences – one that is located in an area of chronic economic distress or a census tract in which at least 70% of the families have an income that is 80% or less of the statewide median income. A qualified home improvement loan may not exceed $15,000.

  This act eliminates the first-time homebuyer requirement with respect to qualified Hurricane Katrina recovery residences. A "qualified Hurricane Katrina recovery residence" is one that

is financed before January 1, 2008, and is either 1) located in the core disaster area or 2) the mortgagor of which owned a principal residence in the Hurricane Katrina disaster area that was rendered uninhabitable by Hurricane Katrina and the residence financed is in the same state as the previous residence.

The act also increases the maximum amount of a qualified home improvement loan to $150,000 for residences located in the Hurricane Katrina disaster area to the extent that the loan is for repair of damage caused by Hurricane Katrina.

- *Extension of replacement period for nonrecognition of gain.* A taxpayer generally realizes gain to the extent the sales price of property exceeds the taxpayer's basis in the property. The realized gain is subject to taxation unless it is deferred or not recognized under some special provision. Gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer replaces the property within the applicable period. The applicable period begins when property is converted and ends two years after the close of the first taxable year in which the gain is realized.

  This act extends the applicable period from two years to five years for property that is located within the Hurricane Katrina disaster area that is compulsorily or involuntarily converted after August 25, 2005, by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be in this area for this provision to apply.

- *Secretarial authority to make adjustments regarding taxpayer and dependency status for taxpayers affected by Hurricane Katrina.* This provision allows the Secretary of the Treasury to make adjustments to the tax laws to ensure that taxpayers do not lose eligibility for credits or deductions or experience a change in filing status due to temporary relocations caused by Hurricane Katrina. An example of such an adjustment would be allowing a parent to claim a personal exemption for a child even if the child did not satisfy the residency requirement as a result of a relocation due to Hurricane Katrina. Any adjustment must ensure that an individual is not taken into account by more than one taxpayer with respect to the same benefit.

Gulf Opportunity Zone Act of 2005 (P.L. 109-135) (GO Act)

The Gulf Opportunity Zone Act of 2005 expanded upon the relief offered in the Katrina Emergency Tax Relief Act of 2005. In some instances, this expansion meant extending the additional benefits allowed under the Katrina Act to taxpayers affected by Hurricanes Rita or Wilma. In other cases, the expansion created new tax benefits for taxpayers in one or more of the disaster areas. The act also made numerous technical corrections.

General Provisions. First, the GO Zone Act added several new definitions. First, the "Gulf Opportunity Zone" or "GO Zone" is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government and is the same as the "core disaster area" under the Katrina Act. The "Hurricane Rita disaster area" means an area with respect to which the President has declared a major disaster before October 6, 2005, with respect to Hurricane Rita. The "Hurricane Wilma disaster area" means an area with respect to which the President has declared a major disaster before November 14, 2005, with respect to Hurricane Wilma. The "Rita GO Zone" and "Wilma GO Zone" are, respectively, the portions of the Hurricane Rita disaster area and Hurricane Wilma disaster area that have been determined by the President to warrant individual or individual and public assistance from the federal government.

Extensions of Hurricane Katrina benefits. The GO Zone Act extended some of the benefits of the Katrina Act to areas affected by Hurricanes Rita and Wilma. The following changes fall into this category.

- *Retirement plans.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Casualty losses.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to that discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Secretarial authority to make adjustments.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Mortgage revenue bonds.* The first-time homebuyer requirement is eliminated for residences in the Rita GO Zone or the Wilma GO Zone. In addition, the increased maximum amount of a qualified home improvement loan is applied to residences in the Rita GO Zone and the Wilma GO Zone.

Housing relief for Hurricane Katrina. As discussed above, the Katrina Act provided some relief to individuals who provided housing for Hurricane Katrina evacuees. In this act, Congress provided further tax relief relating to housing expenditures. Employer-provided housing is generally included in income as a form of compensation. An exception to this general rule exists when an employee is required to accept the lodging on business premises as a condition of employment. This act provides that a qualified employee's gross income does not include the value of any in-kind lodging furnished to the employee, the employee's spouse, or the employee's dependents by or on behalf of the qualified employer. The exclusion applies only to lodging furnished during the six-month period beginning January 1, 2006 and may not exceed $600 for any month in which lodging is furnished. For the purposes of this provision, a "qualified employee" is an individual who on August 28, 2005, had a principal residence in the GO Zone and who performs substantially all of his or her employment services in the GO Zone for a qualified employer. For the purposes of this provision, a "qualified employer" is an employer with a trade or business located in the GO Zone.

Depreciation and expensing.

- *Bonus depreciation for Gulf Opportunity Zone property.* In 2002 and 2003, Congress acted to allow for bonus depreciation (either 30% or 50% depending on when the property was purchased) for property that was purchased after September 10, 2001. In order to qualify for the bonus depreciation, the property had to have been placed into service before January 1, 2005. For certain transportation property, noncommercial aircraft, or property with a long production period, the property must have been placed into service before January 1, 2006.

  This act allows a taxpayer to claim an additional first-year depreciation allowance equal to 50% of the adjusted basis of qualified Gulf Opportunity Zone property acquired on or after August 25, 2005, and placed into service before January 1, 2008 (the sunset date is January 1, 2009, for nonresidential real property and residential rental property). "Qualified Gulf

Opportunity Zone property must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less, MACRS water utility property, qualified leasehold improvement property, off-the-shelf computer software, residential rental property, or nonresidential real property; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The property must be placed in service before January 1, 2008 (January 1, 2009 for nonresidential real property and residential rental property). The term does not include property that is 1) mandatory alternative depreciation system (ADS) property; 2) tax-exempt bond-financed property; 3) qualified revitalization buildings or rehabilitation expenditures for which a deduction under section 1400I of the Code is claimed; or 4) property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

In addition, this act allows the Secretary to extend the placed-in-service date for noncommercial aircraft and property with longer production periods for up to one year. This extension is granted on a case-by-case basis and may only be granted if the delay in placing the property into service was caused by one of the three hurricanes and the property is placed in service in the GO Zone, the Rita GO Zone, or the Wilma GO Zone.

- *Increase in limits on section 179 deductions.* Certain taxpayers may elect to claim a section 179 expense deduction on the cost of qualifying property rather than depreciating the property over time. For the 2003 through 2007 tax years, the maximum amount of the deduction is limited to $100,000, indexed for inflation.[7] This limitation is increased by $35,000 for property that is placed in service in the New York Liberty Zone, an empowerment zone, or a renewal community. The amount of the section 179 deduction is reduced to the extent that the total amount of property placed into service exceeds an investment threshold, currently set at $400,000, indexed for inflation.[8] The section 179 deduction may not exceed a taxpayer's taxable income from the active conduct of a trade or business.

  This act increases the maximum section 179 deduction for qualified GO Zone property by the lesser of $100,000 or the amount of property placed into service in the GO Zone. In addition it increases the total investment limitation by the lesser of $600,000 or the amount of property placed into service in the GO Zone. The increased amounts apply to property acquired on or after August 25, 2005, and placed into service before January 1, 2008. "Qualified GO Zone property" must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The

[7] The adjusted dollar limitation is $105,000 for 2005 and $108,000 for 2006.
[8] The adjusted investment limitation is $420,000 for 2005 and $430,000 for 2006.

property must be placed in service before January 1, 2008. The term does not include property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

- *Deduction for demolition and clean-up costs.* Under general law, demolition costs are capitalized and added to the basis of the land on which the demolished building was located. The tax treatment of debris removal costs depends on the nature of the costs incurred. Debris removal costs that are in the nature of replacement must be capitalized and added to the basis of the property damaged. Other times, debris removal costs may be used to show a decrease in the fair market value of property which could be used to determine the amount of a casualty loss. This act allows a taxpayer to claim a current deduction for 50% of any qualified Gulf Opportunity Zone clean-up costs paid between August 25, 2005, and January 1, 2008. For the purposes of this provision, a "qualified Gulf Opportunity Zone clean-up cost" is an amount paid for the removal of debris, or the demolition of structures, on real property located in the GO Zone if the real property is either held by the taxpayer for use in a trade or business or is inventory in the hands of the taxpayer.
- *Environmental remediation costs.* Under previous law, a taxpayer may elect to deduct, rather than capitalize, certain environmental remediation expenditures incurred in connection with property used in a trade or business for the production of income. This provision expired for expenditures incurred after December 31, 2005. This act extends the expiration date for that provision until December 31, 2007 for qualified environmental remediation expenditures incurred in connection with a qualified site in the GO Zone. In addition, expenditures incurred on or after August 25, 2005, with respect to petroleum products in the GO Zone are included in the deduction.

Federal Determinations.

This bill would reduce the period of time in which a taxpayer must report a federal change from two years to six months. When the federal government corrects or otherwise determines the amount of an estate, gift, or income that is subject to tax, the taxpayer must file a State return that reflects that change. This is so because the State estate, gift, and income taxes are, to varying degrees, based on amounts determined with respect to federal law. The Multistate Tax Commission has adopted a model uniform statute for reporting federal changes. That model uniform statute requires a taxpayer to report those changes within six months. The model statute is intended to bring uniformity to this area among the states. Currently there is a great deal of variety with some states requiring changes to be reported in as little as 90 days to as much as two years. This provision becomes effective July 1, 2006, and applies to federal determinations made on or after that date.

Filing period for nonresident aliens.

Section 6072(c) of the Code requires a nonresident alien to file an income tax return on or before the fifteenth day of the sixth month following the close of the taxable year (June 15th for taxpayer whose taxable year is the calendar year). Under current State law, nonresident alien corporate taxpayers must file a State return by the fifteenth day of the third month following the close of the taxable year (March 15th for a calendar year taxpayer) and nonresident alien individual taxpayers must file a State return by the fifteenth day of the fourth month following the close of the taxable year (April 15th for a calendar year taxpayer). Thus, under current State law a nonresident alien is required to file a State income tax return before the federal tax return is due. This provision would conform the State filing deadlines to

the federal filing deadlines for nonresident aliens and would ease compliance burdens on those taxpayers. These provisions become effective for taxable years beginning on or after January 1, 2006.

Credit for child-care and certain employment-related expenses.

Current State law allows a credit to a taxpayer who is eligible for the federal credit for child-care and employment-related expenses. The amount of the credit is based on a percentage of those expenses up to a certain amount. For the State credit, the amount of expenses that may be taken into consideration when computing the credit are capped at $2,400 when there is one qualifying individual in the household and $4,800 when there is more than one qualifying individual in the household. Until 2003, these limits were the same as those at the federal. In 2003, the federal limits increased to $3,000 and $6,000 respectively. This provision would conform the State limits to the federal limits. This provision also clarifies that the amount of expenses used in calculating the credit may not include any amount excluded from gross income. This provision becomes effective for taxable years beginning on or after January 1, 2006.

0284Draft-SMLY-LYx-284