

**Federal Taxes Weekly Alert, 05/18/2006, Volume 52, No. 20**

## **RIA Special Study: Key provisions in the Tax Increase Prevention and Reconciliation Act**

The Tax Increase Prevention and Reconciliation Act (H.R. 4297), which was signed into law by the President on May 17, 2006, began life as a tax reconciliation bill designed primarily to retroactively extend a number of popular tax breaks that expired at the end of 2005, and extend a number of tax breaks due to expire in future years. Months of partisan wrangling focused on providing at least short-term AMT relief, extending tax breaks such as low-taxed capital gains and dividends due to expire years down the road, and how to pay for at least part of these expensive provisions. The result was a short list of extended provisions, several new tax breaks, and a long list of revenue raisers.

The centerpiece of the Act is AMT relief for individuals for 2006, two more years of low-tax treatment for capital gains and qualified dividends, two more years of favorable Code Sec. 179 expensing provisions for businesses, and a two-year extension of the subpart F active financing exception. To offset the substantial revenue loss from these provisions, the conferees crafted a number of creative provisions for raising revenue to ensure that the Act met the \$70 billion tax reconciliation target. For example, they removed the AGI ceiling for IRA-to-Roth-IRA conversions but only after 2009, and boosted the age at which the kiddie tax applies from under age 14 to under age 18.

This RIA Special Study reviews the Act's key changes, and explains how they affect individuals, corporations and investors.

### **Boosted 2006 AMT Exemption Amounts for Individuals**

For 2005, the maximum AMT exemption amount was \$58,000 for married individuals filing jointly and surviving spouses, \$40,250 for unmarried individuals, and \$29,000 for married taxpayers filing separately. Under pre-Act law, an individual's AMT exemption amounts for 2006 *dropped* to the levels that were in effect for 2000:


- married individuals filing jointly and surviving spouses: \$45,000, less 25% of AMTI exceeding \$150,000 (zero exemption when AMTI is \$330,000).
- unmarried individuals: \$33,750, less 25% of AMTI exceeding \$112,500 (zero exemption when AMTI is \$247,500).
- married individuals filing separately: \$22,500, less 25% of AMTI exceeding \$75,000 (zero exemption when AMTI is \$165,000). But AMTI of married individuals filing separately must be increased by the lesser of \$22,500 or 25% of the excess of AMTI (before considering this increase) over \$165,000.

**New law.** The Act postpones the scheduled decrease in the AMT exemption amounts for individuals for one year and provides new exemption amounts for 2006 that are higher than those that applied for 2005. ( Code Sec. 55(d)(1) , as amended by Act § 301) Under the Act, for tax years beginning in 2006, the exemption amounts for individuals increase to the following amounts:


- married individuals filing jointly and surviving spouses, \$62,550, less 25% of AMTI exceeding \$150,000 (zero exemption when AMTI is \$400,200);
- unmarried individuals, \$42,500, less 25% of AMTI exceeding \$112,500 (zero exemption when AMTI is \$282,500); and
- married individuals filing separately, \$31,275 less 25% of AMTI exceeding \$75,000 (zero exemption when AMTI is \$200,100). But AMTI of married individuals filing separately is increased by the lesser of \$31,275 or 25% of the excess of AMTI (without regard to the exemption reduction) over \$200,100.


## **Nonrefundable Personal Credits Allowed Against Regular and AMT Tax Liability Through 2006**

In 2005, several personal credits could be used against AMT. However, under pre-Act law, for 2006, personal credits, other than the child credit, the adoption credit, and low income saver's credit, couldn't have exceeded the excess of regular tax liability over tentative minimum tax.


 **RIA observation:** This credit limitation could have reduced many personal tax credits even if the taxpayer had no AMT liability.

**New law.** Under the Act, the maximum that may be claimed for personal credits for 2006 will remain the same as in 2005. Thus, for tax years beginning in 2006, the combined total of the Code Sec. 21 dependent care credit, Code Sec. 22 credit for the elderly and permanently and totally disabled, Code Sec. 25 mortgage credit, Code Sec. 24 child tax credit, Code Sec. 25A Hope and Lifetime Learning credits, Code Sec. 23 adoption credit, and Code Sec. 25B lower income saver's credit ("personal credits") is limited to the sum of: (1) regular tax liability reduced by the foreign tax credit allowable under Code Sec. 27(a) , and (2) the AMT. ( Code Sec. 26(a)(2) , as amended by Act § 302)

 **RIA illustration :** In 2006, the Bakers' regular tax is \$7,400, and their tentative minimum tax is \$6,500. They have \$1,200 in higher education credits and no other credits. Under the Act, they may claim the full \$1,200 in higher education credits. Under pre-Act law, although they don't owe AMT, they would be able to claim only \$900 of their education credits (\$7,400 minus \$6,500).

 **RIA observation:** The change allowing the personal credits to offset the AMT benefits middle income individuals who:

- ... have low taxable income (and thus a low regular tax), e.g., because of a large number of personal exemptions;
- ... are subject to the AMT because personal exemptions (as well as the standard deduction and certain itemized deductions) are not allowed in computing the AMT; and
- ... have substantial personal credits.

 **RIA observation:** Any part of the personal credits that isn't used in a tax year is lost, i.e., it cannot be carried over to another tax year.

## Lower Capital Gain Rates Extended for Two Years Through 2010

A noncorporate taxpayer's adjusted net capital gain is taxed at a maximum rate of 15%, or, to the extent it would have been taxed at a 10% or 15% rate if it had been ordinary income, at a maximum rate of 5% (0% for tax years beginning after 2007). ( Code Sec. 1(h) ) Adjusted net capital gain is net capital gain for the tax year (i.e., the excess of net long-term capital gains over net short-term capital losses for a tax year):

... less the sum of specified types of long-term capital gain that are taxed at a maximum rate of 28% (gain on the sale of most collectibles and gain on the unexcluded part of Code Sec. 1202 small business stock) or 25% (unrecaptured section 1250 gain, i.e., gain attributable to real estate depreciation),  
... plus qualified dividend income (see below).

Under pre-Act law, the 0%, 5%, and 15% rates on adjusted net capital gain, which were established under § 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), are due to expire at the end of 2008, and the rates in effect before that (ranging from 8% to 20%) are due to come back into effect.

**New law.** The Act extends for two years the 0%, 5%, and 15% rates on adjusted net capital gain, through tax years beginning before 2011. (Act § 102 amending § 303 of the JGTRRA)

## Lower Capital Gains Rates on Noncorporate Taxpayers' Qualified Dividend Income Extended for Two Years Through 2010

"Qualified dividend income"—generally, dividends received during the tax year from domestic corporations and "qualified foreign corporations," subject to holding period requirements and specified exceptions—is effectively treated as adjusted net capital gain, and therefore taxed at the same rates that apply to adjusted net capital gain.

Under pre-Act law this treatment, which was established under § 303 of JGTRRA, was due to expire at the end of 2008, and qualified dividend income was then to be taxed at ordinary income rates.

**New law.** The Act extends for two years the treatment of qualified dividend income as adjusted net capital gain, through tax years beginning before 2011. (Act § 102 amending § 303 of JGTRRA)

## AGI Ceiling on IRA-to-Roth-IRA Conversions Removed After 2009

Under pre-Act law, an amount in a traditional IRA can be converted to a Roth IRA if for the year in which the amount is withdrawn from the traditional IRA, (1) the taxpayer's modified AGI (not counting the taxable amount of the conversion) does not exceed \$100,000, and (2) he isn't a married individual filing a separate return (unless he lived apart from the spouse during the entire withdrawal year). The \$100,000 limit is figured without regard to required minimum distributions from an IRA. The income resulting from the conversion is included on the return for the tax year in which funds are transferred or

withdrawn from the traditional IRA. However the 10% premature distribution penalty doesn't apply.

Qualified distributions from Roth IRAs aren't included in income. These are distributions made after the five-tax-year period beginning with the first tax year for which the taxpayer or the taxpayer's spouse made a contribution to a Roth IRA established for the taxpayer, including a qualified rollover contribution from an IRA other than a Roth IRA, and that are made: on or after attaining age 59 1/2; at or after death (to a beneficiary or estate); on account of disability, or for a first-time home purchase expense under Code Sec. 72(t)(2)(F) .

Distributions that aren't qualified distributions are treated as made first from contributions to all of an individual's Roth IRAs and are nontaxable to that extent; distributions in excess of contributions are taxable.

In general, distributions are treated as made from contributions to the Roth IRA to the extent that the distribution, when added to all previous distributions from the Roth IRA, doesn't exceed the total amount of all contributions. Contributions are treated as withdrawn in the following order: first, contributions other than qualified rollover contributions (i.e., qualified conversions); second, qualified rollover contributions (on a FIFO basis); third, a distribution allocable to a qualified rollover contribution is allocated first to the part of the contribution required to be included in gross income. ( Code Sec. 408A(d)(4)(B)(ii) ; Reg. § 1.408A-6 , Q&A 8)

Roth IRAs aren't subject to the required minimum distribution rules of Code Sec. 401(a)(9)(A) or the incidental benefit requirements of Code Sec. 401(a) .

**New law.** For tax years beginning after Dec. 31, 2009, the Act: (1) eliminates the \$100,000 modified AGI limit on conversions of traditional IRAs to Roth IRAs, and (2) permits married taxpayers filing a separate return to convert amounts in a traditional IRA into a Roth IRA. Thus, taxpayers may make such conversions without regard to their AGI. ( Code Sec. 408A(c)(3) , as amended by Act § 512(a))

*Tricky income inclusion rules.* IRA-to-Roth-IRA conversions occurring after 2010 are subject to the same income inclusion rules that apply under pre-Act law (that is, the income resulting from the conversion is included on the return for the tax year in which funds are transferred or withdrawn from the IRA). However, a tricky income inclusion rule applies for conversions occurring in 2010. Unless a taxpayer elects otherwise, none of the gross income from the conversion is included in income in 2010; half of the income resulting from the conversion is includible in gross income in 2011 and the other half in 2012. ( Code Sec. 408A(d)(3)(A) , as amended by Act § 512(b))

**Illustration:** Frank Able's IRA has a \$10,000 balance, consisting of deductible contributions and earnings. He does not have a Roth IRA. In Feb. of 2010, Able converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, \$10,000 is includible in gross income. Unless he elects otherwise (i.e., unless he elects to include the entire conversion in income for 2010), \$5,000 of the income resulting from the conversion is included in income in 2011 and \$5,000 in 2012. (Conference Report)

However, income inclusion is accelerated if converted amounts are distributed before 2012 (whether a distribution consists of converted amounts is determined under the pre-Act-law ordering rules). In that case, the amount included in income in the year of the distribution is increased by the amount distributed, and the amount included in income in

2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income.

## Kiddie Tax Applies to Children Under 18

A child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over \$1,700 (for 2006) if that tax is higher than the tax the child would otherwise pay on it. The parents can instead elect to include on their own return the child's gross income in excess of \$1,700 (for 2006).

Under pre-Act law, a child would have been subject to the kiddie if he or she had not attained age 14 before the close of the tax year and either parent of the child was alive at the end of the tax year.

**New law.** Under the Act, for tax years beginning after 2005, a child is subject to the kiddie tax if he or she has not attained age 18 before the close of the tax year; either parent of the child is alive at the end of the tax year; and the child does not file a joint return for the tax year. ( Code Sec. 1(g)(2)(A) , as amended by Act § 510(a))



**RIA observation:** Thus, while it boosts the kiddie tax age by 4 years, the Act also adds a new exception from the tax so that it doesn't apply to a child who is married and files a joint return for the year.



**RIA observation:** IRS treats an individual born on Jan. 1 as being born on Dec. 31 for kiddie tax purposes. Thus, a child born on Jan. 1, '89 will not be subject to the kiddie tax for 2006.

The Act also creates an exception to the kiddie tax for distributions from certain qualified disability trusts (as defined in Code Sec. 642(B)(2)(c)(II) ).

*Kiddie tax strategies.* The opportunity to lower taxes, by transferring cash or income producing assets to children under 18, is curtailed by the kiddie tax. But investing a child's funds in one or more of the following can help to avoid the kiddie tax:

- ... Savings bonds. Cash basis owners of Series EE and Series I bonds may defer reporting any interest (i.e., the bond's increase in value) until the year of final maturity, redemption, or other disposition.
- ... Municipal bonds. Such bonds produce tax-free income (although the interest on some specialized types of bonds may be subject to the AMT).
- ... Growth stocks. Stocks that pay little dividends and focus more on capital appreciation. The child could sell them after he turns 18 and possibly benefit from being in a low tax bracket.
- ... Mutual funds. Funds can be invested in mutual funds that concentrate on growth stocks and municipal bonds that limit current income and taxes. They may also limit risk through investment diversification.
- ... Real estate. Unimproved real estate that will appreciate over time and doesn't produce current income will limit the impact of the kiddie tax.

Also, it should be borne in mind that a family business can employ a child. The child's earning won't be subject to kiddie tax and will generate a deduction for the family business (assuming the wages are reasonable for work actually performed). The child's

earned income that isn't sheltered by the standard deduction for a dependent will be subject to tax at the child's and not the parent's tax rate.

## **Modified Rules for Loans to Qualified Continuing Care Facilities**

Below-market-interest rules generally are treated as loans bearing interest at the market rate, accompanied by imputed payments characterized in accordance with the substance of the transaction (for example, as a gift, compensation, a dividend, or interest). Pre-Act law provides an exception to these imputed interest rules for a below-market loan made by a lender to a qualified continuing care facility under a continuing care contract, if the lender or the lender's spouse attains age 65 before the close of the calendar year. The exception applies only to the extent the aggregate outstanding loans by the lender (and spouse) to any qualified continuing care facility do not exceed \$163,300 (for 2006).

A continuing care contract is a written contract between an individual and a qualified continuing care facility under which: (1) the individual or his spouse may use a qualified continuing care facility for their life or lives; (2) he or his spouse will first reside in a separate, independent living unit with additional facilities outside the unit for meals and other personal care and won't require long-term nursing care, and then will be provided long-term and skilled nursing care as health needs require; and (3) no additional substantial payment is required if he or his spouse requires increased personal care services or long-term and skilled nursing care.

A qualified continuing care facility means one or more facilities: (1) that are designed to provide services under continuing care contracts; (2) that include an independent living unit, plus an assisted living or nursing facility, or both; and (3) substantially all of the independent living unit residents of which are covered by continuing care contracts. For these purposes, a nursing home is not a qualified continuing care facility.

**New law.** The Act lowers the age of lenders or their spouses who may qualify for the continuing care facility exception to the below-market loan rules from age 65 to age 62. It also provides that a continuing care contract is a written contract between an individual and a qualified continuing care facility under which the individual or the individual's spouse:

- ... may use a qualified continuing care facility for their life or lives;
- ... will be provided with housing, as appropriate for their health (a) in an independent living unit (which has additional available facilities outside such unit for meals and other personal care), and (b) in an assisted living facility or a nursing facility, as is available in the continuing care facility; and
- ... will be provided assisted living or nursing care as health needs require, and as is available in the continuing care facility.

IRS is to issue guidance that limits the term "continuing care contract" to contracts that provide only facilities, care, and services described above. The Conference Committee Report explains that "assisted living facility" is intended to mean a facility at which assistance is provided (1) with activities of daily living (such as eating, toileting, transferring, bathing, dressing, and continence) or (2) in cases of cognitive impairment, to protect the health or safety of an individual. The term "nursing facility" is intended to mean a facility that offers care requiring the utilization of licensed nursing staff. ( Code Sec. 7872(b) , as amended by Act § 209)

The above changes apply for calendar years beginning after Dec. 31, 2005, with respect to loans made before, on, or after that date, but will not apply to any calendar year after

2010. Thus, the conference agreement provision does not apply with respect to interest imputed after Dec. 31, 2010. After that date, pre-Act law will apply.

### **Capital Gain Treatment for Self-Created Musical Works**

Under pre-Act law, capital assets do not include copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property). As a result, when a taxpayer sells copyrights he owns in, for example, books, songs, or paintings that he created (or when a taxpayer to which the copyrights have been transferred by the works' creator in a substituted basis transaction sells such copyrights), gain from the sale is treated as ordinary income, not low-taxed capital gain.

**New law.** Under the Act, at the election of a taxpayer, a pre-Jan. 1, 2011 sale or exchange of musical compositions or copyrights in musical works created by the taxpayer's personal efforts (or having a basis determined by reference to the basis in the hands of taxpayer whose personal efforts created the compositions or copyrights) is treated as the sale or exchange of a capital asset. The change applies for sales or exchanges in tax years beginning after May 17, 2006. ( Code Sec. 1221(b) , as amended by Act § 204)

### **Enhanced Code Sec. 179 Expensing Election Extended Two Years Through 2009**

A taxpayer, other than an estate, trust, and certain noncorporate lessors, may elect under Code Sec. 179 to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in his trade or business. The maximum dollar amount that may be deducted annually is \$100,000 (\$108,000 for 2006, as adjusted for inflation). Under pre-Act law, this amount was to drop to \$25,000 for property placed in service in tax years beginning after 2007.


The taxpayer's maximum annual Code Sec. 179 expensing amount is reduced dollar-for-dollar by the amount of qualified expensing-eligible property that he places in service during the tax year in excess of a phaseout amount. This amount is \$400,000 (\$430,000 for 2006, as adjusted for inflation). Under pre-Act law, this amount was to drop to \$200,000 for property placed in service in tax years beginning after 2007. Under pre-Act law, the \$100,000 and the \$400,000 amounts are indexed annually for inflation for tax years beginning after 2003 and before 2008.

Off-the-shelf computer software qualifies as "section 179 property" eligible for the Code Sec. 179 expense election, but under pre-Act law, could not qualify in tax years beginning in 2008 and later.

A Code Sec. 179 election or a revocation may be made, without IRS's consent, on an amended federal tax return for the tax year to which the election or revocation applies, but under pre-Act law, could not be so made in tax years beginning after 2007.

**New law.** The Act extends the \$100,000 expense election limit and the \$400,000 phaseout ceiling (as inflation adjusted), the inclusion of off-the-shelf computer software in eligible "section 179 property," and the right to amend or revoke an expense election

without IRS's consent for two years, to tax years beginning before 2010. ( Code Sec. 179 , as amended by § 101 Act)


 **RIA observation:** Thus, unless Congress changes the rules again, for property placed in service in tax years beginning after 2009, the \$100,000 expensing maximum will drop to \$25,000, the \$400,000 phaseout ceiling will drop to \$200,000, off-the-shelf computer software will not qualify as Code Sec. 179 property, and taxpayers will not be able to make or revoke a Code Sec. 179 election on an amended federal tax return without IRS's consent.

## Only Domestic Production Wages Apply in Code Sec. 199 W-2 Wage Limit

Taxpayers can claim a deduction to offset income from domestic manufacturing and other domestic production activities. The Code Sec. 199 deduction equals the lesser of:

(1) a percentage of the smaller of: (a) the taxpayer's "qualified production activities income" (QPAI) for the tax year, or (b) the taxpayer's taxable income (modified adjusted gross income, for individual taxpayers), without regard to the Code Sec. 199 deduction, for the tax year. The percentage is 3% for tax years beginning in 2005 and 2006, 6% for tax years beginning in 2007-2009, and 9% in later years.

(2) 50% of the W-2 wages of the employer for the tax year. Under pre-Act law, these wages are the sum of the aggregate amounts that must be included on the Forms W-2 of employees under Code Sec. 6051(a)(3) (i.e., wages subject to withholding) and Code Sec. 6051(a)(8) (elective deferrals).

 **RIA observation:** Under pre-Act law, there was nothing in the definition of W-2 wages that required those wages to be allocable or attributable to activities that give rise to the U.S. production activities deduction. Thus, if the taxpayer engaged some employees in activities that generated the deduction, and other employees in activities that did not, the wages of all of those employees could be treated as W-2 wages.

QPAI is the excess (if any) of: (i) domestic production gross receipts for that tax year, over (ii) the sum of the cost of goods sold that are allocable to those receipts; and other expenses, losses, or deductions (other than the Code Sec. 199 deduction) which are properly allocable to those receipts. ( Code Sec. 199(c)(1) ) Domestic production gross receipts are the taxpayer's gross receipts derived from:

... any sale, exchange or other disposition, or any lease, rental or license of qualifying production property that was manufactured, produced, grown or extracted "by the taxpayer" in whole or "in significant part" within the U.S.;

... any qualifying disposition of qualified films produced by the taxpayer;

... any qualifying disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.;

... construction activities performed in the U.S. by a taxpayer in the active conduct of a construction trade or business; or

... engineering or architectural services, performed in the U.S. for construction projects located in the U.S., by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business. ( Code Sec. 199(c)(4) )

*S corporations and partnerships.* Under pre-Act law, when applying the 50% of W-2-wages limit on the Code Sec. 199 deduction available to an S shareholder or partner, each is treated as having W-2 wages for the tax year in an amount equal to the lesser of:

- ... that person's allocable share of the W-2 wages of the entity, or
- ... two times the specified percentage (for tax years beginning in 2005 or 2006, 3%) of the QPAI allocated to that person for the tax year.

**New law.** For tax years beginning after May 17, 2006, the Act provides that for Code Sec. 199 purposes, W-2 wages only include amounts that are properly allocable to domestic production gross receipts. ( Code Sec. 199(b)(2)(B) , as amended by Act § 514)



**RIA illustration :** M Corp has two operations that each employs 100 workers: (1) one that manufactures a product and that results in domestic production gross receipts and QPAI; (2) one that provides a service to customers that doesn't result in domestic production gross receipts or QPAI. Under the Act, the wages from M Corp's 100 service operation workers aren't taken into account in calculating its 50% of W-2 wage limit.

Additionally, effective for tax years beginning after May 17, 2006, the Act repeals the special limitation on wages treated as allocated to partners or shareholders of pass-through entities for purposes of the W-2 wage limit. Instead, each partner or shareholder is treated as having the W-2 wages for the tax year equal to his allocable share of the partnership's or S corporation's W-2 wages for the tax year. ( Code Sec. 199(d)(1)(A)(iii) , as amended by Act § 514)

## **“Active Conduct of a Trade or Business” For Code Sec. 355 Redefined**


One of the requirements for a Code Sec. 355 tax-free corporate division (e.g., a spin-off) is that the distributing corporation (D) and any controlled corporation (C) that it distributes must be engaged in the active conduct of a trade or business. This requires either that: (1) immediately after the distribution D and C are engaged in the active conduct of a trade or business, or (2) immediately before the distribution, D had no assets other than stock or securities of controlled corporations and, immediately after the distribution, each of the controlled corporations is engaged in the active conduct of a trade or business.

Under pre-Act law, a corporation satisfied the above active conduct of a trade or business test, if:

- (A) it is engaged in the active conduct of a trade or business, or
- (B) substantially all of its assets consisted of stock and securities of a corporation it controlled immediately after the distribution and the controlled corporations are engaged in the active conduct of a trade or business.

**New law.** For distributions made after May 17, 2006 and before Jan. 1, 2010, subject to a transition rule, the Act provides that corporation is treated as satisfying the active conduct of a trade or business test under Code Sec. 355(b)(2) , if, and only if, it is engaged in the active conduct of a trade or business. ( Code Sec. 355(b)(3)(A) , as amended by § 202) For these purposes, all members of the corporation's “separate affiliated group” are treated as one corporation. For this purpose, a “separate affiliated group” as to any corporation is the affiliated group which would be determined under

Code Sec. 1504(a) if the corporation were the common parent and Code Sec. 1504(b) exclusions did not apply. ( Code Sec. 355(b)(3)(B) , as amended by § 202) Thus, the Act provision simplifies the active business test for tax-free corporate spin-offs by looking at all corporations in the distributing corporation's and the spun-off subsidiary's respective affiliated group to determine if the active business test is satisfied. As a result, it makes it easier for corporate groups that use a holding company structure to engage in tax-free corporate divisions. (Conf Rept)

 **RIA observation:** Under pre-Act law, a corporate group often had to undergo elaborate restructuring to satisfy the active trade or business requirement, particularly if the distributing corporation was a holding company that did not directly engage in a trade or business.

## **Elective Amortization of Expenses for Creating or Acquiring Music**


Under pre-Act law, the cost of motion picture films, sound recordings, copyrights, books, patents, and certain other property is eligible to be depreciated under the income forecast method. In general, the deduction under this method is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year, and the denominator of which is the total forecasted or estimated income expected to be generated before the close of the 10th tax year after the property was placed in service. The deduction for the 10th tax year following that in which the property was placed in service equals the taxpayer's entire remaining basis in the property. ( Code Sec. 167(g)(1)(C) )

Alternately, under the elective safe harbor, eligible taxpayers—individuals, and corporations or partnerships, substantially all of which are owned by one qualified employee owner (an individual and family members)—can capitalize qualified created costs by amortizing 50% of the costs in the tax year incurred, and 25% in each of the two successive tax years. Qualified creative costs generally are those incurred by a self-employed individual in the production of creative properties (e.g., films, sound recordings, musical and dance compositions), if the personal efforts of the individual predominantly create the properties.

**New law.** The Act provides that for any tax year beginning after Dec. 31, 2005 and before Jan. 1, 2011, a taxpayer may elect to amortize over a 5-year period expenses: (a) paid or incurred to create or acquire a musical composition (including words), or a copyright to such property; and (b) that are otherwise properly capitalizable. The 5-year period begins with the month in which the composition or copyright is placed in service. ( Code Sec. 167(g)(8) , as amended by § 207)

The 5-year amortization election doesn't apply to expenses:

... that are qualified creative expenses under Code Sec. 263A(h) (which aren't required to be capitalized under the uniform capitalization rules);  
... to which a simplified procedure established under Code Sec. 263A(j)(2) applies;

 **RIA observation:** There is no Code Sec. 263A(j)(2). The above reference to Code Sec. 263A(j)(2) is apparently an error that will need to be addressed in a technical corrections. Presumably, the reference is to

Code Sec. 263A(h)(2) , and meant to refer to the elective safe harbor for qualified creative costs discussed above.

- ... that are amortizable section 197 intangibles; or
- ... that, without regard to this provision, would not be allowable as a deduction.

The election is to be made in time and manner specified by IRS, and it applies to all musical property placed in service for the tax year. ( Code Sec. 167(g)(8)(D) )

## **Amortization of Geological and Geophysical Expenses**

Geological and geophysical expenditures (G&G) are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. G&G costs incurred in connection with oil and gas exploration in the U.S. may be amortized over 2-years. For abandoned property, basis is still recovered over the 2-year amortization period.

**New law.** For amounts paid or incurred after May 17, 2006, the Act extends the 2-year amortization period for G&G costs to 5-years for certain major integrated oil companies. Similarly, for abandoned property, basis is recovered over a 5-year amortization period. The 5-year amortization rule applies to integrated oil companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the tax year, gross receipts in excess of \$1 billion in the last tax year ending during calendar year 2005, and an ownership interest in a crude oil refiner of 15% or more. ( Code Sec. 167(h)(5) , as amended by § 503)

## **Earnings Stripping Rules For Corporate Partners Codified**

Special rules limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Under Code Sec. 163(j) , the deductibility of interest paid to certain related parties ("disqualified interest") is limited if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50% of its "adjusted taxable income" (i.e., taxable income without regard to deductions for net interest expense, net operating losses, depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. Any excess limitation (i.e., any excess of the 50% limit over a company's net interest expense for a given year) can be carried forward three years.

Prop Reg § 1.163(j)-3(b)(3) provides that a partner's proportionate share of partnership liabilities is treated as liabilities incurred directly by the partner, for purposes of applying the earnings stripping limitation to interest payments by a partnership's corporate partner. Prop Reg § 1.163(j)-2(e)(4) provides that interest paid or accrued to a partnership is treated as paid or accrued to the partnership's partners in proportion to each partner's distributive share of the partnership's interest income for the tax year. In addition, Prop Reg § 1.163(j)-2(e)(5) provides that interest expense paid or accrued by a partnership is treated as paid or accrued by the partnership's partners in proportion to each partner's distributive share of the partnership's interest expense.

**New law.** For tax years beginning on or after May 17, 2006, the Act codifies the above proposed regs by providing that, in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation's share of partnership liabilities, interest income, and interest expense are treated as liabilities, interest income, and

interest expense of the corporation in applying the earnings stripping rules to the corporation. ( Code Sec. 163(j)(8) , as amended by § 501)

## **No Tax-Free Code Sec. 355 Treatment For Disqualified Investment Companies**

Under pre-Act law, where a corporation distributed the stock of its controlled subsidiary in a transaction intended to be a tax-free corporate division under Code Sec. 355 , there were no specific limits on the investment assets that could be held by the distributing or controlled corporation. If both were engaged in the active conduct of a trade or business, most of their assets could represent passive investments, although the presence of substantial non-business assets might be a factor indicating that the distribution was a proscribed device to distribute earnings and profits.

**New law.** Generally effective for distributions after May 17, 2006, the Act denies tax-free Code Sec. 355 treatment to distributions where either the distributing or distributed corporation is a disqualified investment corporation immediately after the transaction (including any series of related transactions) and any person that did not hold 50% or more of the voting power or value of stock of the distributing or controlled corporation immediately before the transaction holds a 50% or greater interest immediately after the transaction. A disqualified investment corporation is any distributing or controlled corporation if the fair market value of the investment assets of the corporation is two-thirds or more of the value of the corporation's total assets (three-fourths of the value for distributions after May 17, 2006 and before May 18, 2007). ( Code Sec. 355(g) , as amended by § 507)

*Investment assets defined.* In general, investment assets are cash; any stock or securities in a corporation; any interest in a partnership; any debt instrument or other evidence of indebtedness; any option, forward or futures contract, notional principal contract, or derivative; foreign currency; or any similar asset. Investment assets don't include any asset which is held for use in the active and regular conduct of a lending or finance business or a banking business (through a bank, a domestic building and loan association, etc.), or a licensed, authorized, or regulated insurance business. Investment assets also do not include securities held by a dealer in securities to which the marked to market rules apply.

Further, investment assets don't include any stock or securities in, or any debt instrument, evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative issued by, a corporation which is a 20% controlled entity with respect to the distributing or controlled corporation—i.e., any corporation for which the corporation (distributing or controlled) owns directly or indirectly stock possessing at least 20% of the total voting power and value of the corporation's stock. Under a look-through rule, the distributing or controlled corporation will be treated as owning its ratable share of the assets of any 20% controlled entity. ( Code Sec. 355(g)(2)(B) , Conf Rept)

Investment assets also do not include any interest in a partnership, or any debt instrument or other evidence of indebtedness issued by the partnership, if one or more trades or businesses of the partnership are, (or without regard to the 5-year requirement of Code Sec. 355(b)(2)(B) ), would be taken into account by the distributing or controlled corporation, in determining whether the active business test for Code Sec. 355 is met by the corporation. ( Code Sec. 355(g)(2)(B) )

## Other Changes Made by the Act

The Act includes many other changes, including the following provisions:

... The exception under subpart F for active financing and insurance income is extended for two years, to tax years of foreign corporations beginning before Jan. 1, 2009, and for any tax year of a U.S. shareholder with or within which the tax year of the foreign corporation ends. ( Code Sec. 953(e)(10) , as amended by Act § 103(a)(1), Code Sec. 954(h)(9) , as amended by Act § 103(a)(2))

... The Act creates a new temporary exception from subpart F for dividends, interest, rents and royalties received by one CFC (controlled foreign corporation) from a related CFC to the extent attributable to non-subpart F income of the payor. The change is effective for tax years of foreign corporations beginning after Dec. 31, 2005 and before Jan. 1, 2009, and for any tax year of a U.S. shareholder with or within which the tax year of the foreign corporation ends. ( Code Sec. 954(c)(6)(A) , as amended by Act § 103(b))

... Corporations with assets of at least \$1 billion will face a modified schedule of estimated tax payments. Those payments due in July, Aug., and Sept. of 2006 are increased to 105% of the payment otherwise due, and the next required payment is reduced accordingly. Payments due in July, Aug., and Sept. of 2012, are increased to 106.25% of the payment otherwise due, and the next required payment is reduced accordingly. Finally, payments due in July, Aug., and Sept. of 2013, are increased to 100.75% of the payment otherwise due, and the next required payment is reduced accordingly. (Act § 401)

... Also, under the Act, notwithstanding Code Sec. 6655 , 20.5% of the amount of any required installment of corporate estimated tax that is otherwise due on Sept. 15, 2010 is not due until Oct. 1, 2010. Likewise, 27.5% of the amount of any required installment of corporate estimated tax that is otherwise due on Sept. 15, 2011 is not due until Oct. 1, 2011. (Act § 401)

... Information reporting is required for interest paid on tax-exempt bonds after Dec. 31, 2005. ( Code Sec. 6049(b)(2) , as amended by Act § 502)

... Taxpayers must make partial payments to IRS while their offer-in-compromise is being considered by IRS, effective for offers-in-compromise submitted on and after July 16, 2006. For lump-sum offers (which include single payments, as well as payments made in 5 or fewer installments), taxpayers must make a down payment of 20% of the amount of the offer with any application. User fees are eliminated for offers submitted with the appropriate partial payment. ( Code Sec. 7122 , as amended by Act § 509)