

# A L E R T

## TAX RELIEF & HEALTH CARE ACT OF 2006

### **PRESIDENT BUSH SIGNS THE TAX RELIEF & HEALTH CARE ACT OF 2006**

President Bush has signed into law a much-anticipated “extenders package” that retroactively restores some popular expired tax cuts to the start of 2006. However, there’s much more. The new law also enhances some important tax incentives, bolsters Health Savings Accounts, revises deadlines for certain excise taxes, extends some expiring energy credits, makes critical “technical corrections” to existing tax laws, and includes an impressive list of “miscellaneous” tax relief.

The popular extenders had been moved from one bill to another during 2006 until passed at the last possible moment by a lame-duck Congress as part of a larger health and trade bill. In addition to its \$45.1 billion in tax benefits, the new law brings with it special problems, and opportunities, for year-end tax planning and the 2007 tax season.

#### **Extended / Enhanced Tax Breaks**

The extenders portion of the new law was a “must-pass” for Congress. A simple extenders package likely would have been enacted sooner had it not been attached to more controversial pieces of legislation, such as a bill to reduce the federal estate tax. Senator Max Baucus, D-Montana, who is expected to become chairman of the powerful tax-writing Senate Finance Committee in the new 110th Congress commented, “next year, we need to tackle expiring tax cuts earlier, so Americans won’t have to wonder whether Congress will come through.”

#### **Deduction for State and Local Sales Taxes**

The American Jobs Creation Act of 2004 allowed taxpayers to deduct either state and local income taxes or state and local general sales taxes as an itemized deduction. This deduction expired on December 31, 2005. However, the popularity of the deduction, especially among residents of states without an income tax, did not go unnoticed on Capitol Hill. Thus, the new law extends it through 2007.

#### **Higher Education Tuition Deduction**

The new law extends the popular above-the-line higher education tuition deduction through 2007.

For 2006, and again in 2007, a \$4,000 above-the-line education deduction is available each year to single taxpayers with adjusted gross incomes (AGI) of \$65,000 or less (\$130,000 for joint filers). A \$2,000 above-the-line education deduction is available to single taxpayers with adjusted gross incomes up to \$80,000 (\$160,000 for joint filers). These are the same levels set for the deduction in 2004 and 2005.

### **Teacher's Classroom Expense Deduction**

Teachers and other education workers can deduct, above the line, up to \$250 of certain out-of-pocket classroom expenses. This deduction recognizes that many education professionals purchase classroom supplies with their own money. This popular deduction, which in 2005 was claimed by more than 3,000,000 taxpayers, expired at the end of 2005. The new law extends it through 2007.

Instructors, counselors, principals, and classroom aides, as well as teachers, who work at least 900 hours during the school year, are eligible to take the deduction. Qualifying taxpayers, however, must work in a kindergarten, elementary or secondary school through Grade 12.

Qualifying expenditures include classroom supplies, such as paper, pens, glue, and scissors, as do purchases of books and computer equipment, including software. For courses in health and physical education, the supplies must relate to athletics.

### **Research Tax Credit**

The new law extends the research tax credit to amounts paid or incurred in 2006 and 2007. For 2007, the new law also makes two enhancements that could make the credit more valuable for many businesses.

The research credit is generally equal to 20% of the taxpayer's "qualified research expenses" that exceed a base amount. However, a taxpayer may elect to take the alternative incremental credit (AIC). The AIC uses a "stated percentage" of qualified expenses that exceed the taxpayer's average research expenditures over four years.

The new law increases the "stated percentage" beginning in 2007. Taxpayers on a fiscal year will take into account the percentage that applies to each calendar year. The amounts are:

- 2.65% (increasing to 3% in 2007) of qualified research expenses between 1 and 1.5% of average annual gross receipts;
- 3.2% (increasing to 4% in 2007) of qualified expenses between 1.5 and 2% of average annual gross receipts; and
- 3.75% (increasing to 5% in 2007) of qualified expenses exceeding 2%.

The new law also creates an Alternative Simplified Credit for 2007. Under the simplified method, the credit is 12% of the qualified research expenses that exceed 50%

of the average qualified research expenses for the three preceding tax years. If the taxpayer has no qualified expenses in any one of the preceding three years, the credit is 6% of the current qualified research expenses.

### **Work Opportunity and Welfare-to-Work Tax Credits**

Congress created the Work Opportunity and Welfare-to-Work tax credits to give employers tax incentives to hire economically disadvantaged individuals. The new law retroactively renews the two popular credits for 2006 and for 2007, combines them, with enhancement, into one credit.

The credits continue to target specific groups of economically challenged individuals. In connection with qualifying groups, the new law repeals the requirement that an ex-felon be from an economically disadvantaged family and raises the age ceiling for food stamp recipients from age 25 to 40. Employers also are given additional time to file certification paperwork with the government.

The new law does not tinker with the total amount of the credit (although it makes the computation easier by coordinating the definition of “qualifying worker”). For most targeted groups, the credit is 40 % of qualified first year wages (25 % if employment is more than 120 but less than 400 hours). Qualified first year cannot exceed \$6,000. Separate computations apply for recipients of long-term family assistance and summer youth employees.

### **Leasehold and Restaurant Improvements**

The new law extends the 15-year recovery period for certain leasehold and restaurant improvements through 2007. Generally, qualified leasehold improvement property is any improvement to an interior portion of a nonresidential building. Some items, such as elevators and escalators, are expressly excluded. Certain improvements to restaurants also qualify for the tax break.

### **Brownfields Remediation Costs**

In 1997, Congress gave taxpayers a special incentive to promote the clean up of brownfields (areas that are contaminated by industrial waste and toxins). Taxpayers can elect to deduct, rather than capitalize, some environmental remediation costs. This special treatment has been extended through 2007 and was expanded to cover the clean up of certain petroleum products for payments made during 2006 and 2007.

### **Qualified Zone Academy Bonds**

Congress has authorized state and local governments to issue special tax-exempt bonds, known as qualified zone academy bonds, to fund educational improvements. The new law renews the authority of state and local governments to issue these bonds for 2006 and 2007 and provides special new rules as to required expenditures, arbitrage and reporting requirements.

## **Corporate Donations of Computer and Scientific Equipment**

The new law extends and enhances through 2007 the deduction for corporate donations of scientific property used for research, computer equipment, and technology to schools and public libraries. For contributions made after 2005, the provision expands the deduction to allow equipment “assembled by” the donor to qualify for the deduction.

## **New Markets Tax Credit**

Under the New Markets Tax Credit program, investors receive a credit against federal income taxes for making qualified equity investments in economically distressed communities. The new law extends the credit through the end of 2008 and requires that regulations be provided to ensure that non-metropolitan counties received a proportional allocation of qualified equity investments.

## **Earned Income Tax Credit for Combat Pay**

Military personnel can elect to include tax-free combat pay in income for purposes of computing the earned income credit. This provision is available for tax years ending before January 1, 2008.

## **GO Zone Bonus Depreciation**

The new law extends the placed-in-service deadline from December 31, 2007 to December 31, 2010 for taking the 50% bonus depreciation deduction for certain Gulf Opportunity (GO) Zone property.

### *Types of Property*

The extension applies to nonresidential real property and residential rental property. Only the adjusted basis of such property attributable to the manufacture, construction, or production before January 1, 2010 would qualify for bonus depreciation.

### *Personal Property*

The placed-in-service deadline is also extended for personal property used in a building within 90 days of the date the building is placed in service.

## **Qualified Veterans' Mortgage Bonds**

Qualified veterans' mortgage bonds provide proceeds for mortgage loans to veterans. Five states are eligible to issue these bonds. The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) revised eligibility requirements and changed the annual volume limits for bonds issued by Alaska, Oregon and Wisconsin. These changes have been made permanent.

## **Health Savings Account Enhancements**

The new law enhances the use of health savings accounts (HSAs). Unlike the extenders, the HSA enhancements are permanent and most take effect for tax years beginning after 2006.

## **FSA Rollovers**

Employees with a health flexible spending account (FSA) or a health reimbursement account (HRA) will be allowed to make a one-time transfer of the balance in their FSA or HRA to an HSA. The maximum transfer amount is the lesser of the balance as of the date of transfer or September 21, 2006. The transfer must be made before January 1, 2012.

## **IRA Rollovers**

The new law allows employees a one-time, once-in-a-lifetime, rollover of funds from their IRAs into an HSA. The election to make the rollover is irrevocable. The change is designed to give employees quicker access to their funds for medical expenses. The provision applies to tax years beginning after December 31, 2006.

## **And More...**

The new law also repeals the limits on deductible annual contributions, modifies cost of living adjustments, expands the contribution limit for part-year coverage, treats certain FSAs as disregarded coverage, and favorably modifies the comparable contribution rules.

## **Energy Extenders**

The new law renews several temporary energy incentives. These were enacted as part of the Energy Tax Incentives Act of 2005 (2005 Energy Act).

## **Deduction for Energy Efficient Commercial Buildings**

Qualifying taxpayers may deduct costs associated with energy-efficient commercial building property. The property had to be placed in service after December 31, 2005, and before January 1, 2008. The new law extends this deduction through 2008.

## **Business Credit for Energy Efficient New Homes**

Eligible contractors may claim a tax credit for qualified new energy-efficient homes that they construct and that an individual acquires from the contractor in 2006 and 2007. The credit is generally \$2,000 for a new energy-efficient home and \$1,000 for a new energy-efficient manufactured home. The new law extends the credit through 2008.

### **Credit for Residential Alternative Energy Expenditures**

The 2005 Energy Act provided a non-refundable personal tax credit of 30% of the cost of eligible solar water heaters, solar electricity equipment (photovoltaics), and fuel cell plants. The maximum credit is \$2,000 per tax year for each category of solar equipment and \$500 for each half kilowatt of capacity of fuel cell plants installed per tax year. The new law extends the credit through 2008.

### **Renewable Electrical Energy Production Credit**

The 2005 Energy Act expanded the types of qualified energy resources available for the renewable electrical energy production credit. Generally, electricity must be produced at a qualified facility, such as a wind energy facility. The new law extends the placed-in-service date for qualifying facilities for one year through 2008.

### **Clean Renewable Energy Bonds**

The 2005 Energy Act authorized the issuance of up to \$800 million in tax credit bonds, known as clean renewable energy bonds (CREBs), to finance production of electricity from clean renewable sources. Issuance of these bonds was limited to 2006 and 2007. The new law extends this authority through 2008.

### **More Energy Incentives...**

Other energy provisions impacted by the new law include:

- Modifying the advanced coal credit with respect to sub-bituminous coal;
- Extending the credit for business installation of qualified fuel cells, stationary micro-turbine power plants, and solar panels;
- Extending the reduced excise tax on methanol or ethanol fuel derived from coal;
- Providing a 25% exclusion for capital gains from sale of an interest in a mineral or geothermal deposit on certain federal land to tax-exempt entities; and
- Suspending the limit on percentage depletion for oil and gas produced from marginal wells for tax years beginning in 2006 and 2007.

### **More Regular Extenders**

Although addressing the high-profile expired provisions, Congress also took the opportunity to deal with other temporary provisions that either had expired or were about to expire. These provisions were initially made temporary either because Congress wanted to re-evaluate them after a test period or because the budget money was not available at the time to make them permanent.

The following additional temporary tax breaks continue without interruption through 2007:

- Availability of Archer Medical Savings Accounts (MSAs);
- Indian employment tax credit to assist economically-challenged Native Americans;
- Accelerated depreciation for certain business property on a Native American reservation;
- D.C. Enterprise Zone and first-time homebuyers tax breaks; and
- IRS' authority to impose an excise tax on a group health plan's failure to give parity to mental health benefits.

### **And Even More Tax Relief...**

The other tax provisions in the Tax Relief and Health Care Act of 2006 are a gold mine of tax opportunities for a wide variety of taxpayers. Some of the more notable provisions include:

- A refundable credit worth up to 20% for the next five years, to certain taxpayers with long-term unused AMT credits who have AMT income from incentive stock options;
- An itemized mortgage insurance premium deduction available on qualified residences, with phase-out starting at \$100,000 AGI, for 2007 only;
- Giving the Tax Court jurisdiction over stand-alone non-deficiency equitable innocent spouse relief;
- Expansion of the Code Sec. 199 manufacturing deduction to U.S. businesses with manufacturing activities in Puerto Rico for 2006 and 2007;
- A 50% first-year expensing deduction permitted for qualified underground mine equipment that exceeds current safety requirements, for costs incurred after the date of enactment for equipment placed in service before December 31, 2008;
- A credit of up to \$10,000 for training mine rescue team members, effective for 2006 through 2008;
- Increased rewards available under the IRS whistleblower program and the creation of a whistleblower office within the IRS;
- Permanent modification to the definition of active business under Code Sec. 355;
- Permanent capital gains treatment for self-created musical works;
- Tolling the five-year period in the home sale exclusion rules for up to ten years for employees in the intelligence community;
- Modification of the unrelated business income tax on charitable remainder trusts;
- Permanent special rule for loans to qualified continuing care facilities;
- Technical corrections to enable proper application of the look-through treatment of payments between related controlled foreign corporation under the foreign personal holding company rules; and
- Technical corrections to allow broader Treasury delegation of the authority to suspend interest where taxpayers involved in certain tax shelter activities have acted reasonably and in good faith.

## IRS Operations

The new law extends the IRS' authority for undercover operations and the agency's enhanced information sharing. Undercover operations may continue through 2007 and information sharing may continue through 2007.

Other IRS provisions include:

- Changing to the IRS' reward program for taxpayers who turn in tax cheats; and
- Boosting the penalty for frivolous returns and other submissions to \$5,000 from \$500.

## Looking Ahead to 2007

It's a whole new ballgame on Capitol Hill in January with Democrats in charge of both the House and the Senate for the first time in many years. Democrats are promising to change the direction of Congress in the "first 100 hours." They are also anticipating longer work weeks and shorter recesses.

Tax legislation is high on their agenda. Representative Nancy Pelosi, D - California, the next Speaker of the House, and Senator Harry Reid, D-Nevada, the next majority leader in the Senate, have promised to target tax relief to middle-income Americans. Although specifics are still being thrashed out, the Democratic leaders want to see movement on tax incentives for education and working families. They also are looking at scaling back some tax breaks for big oil companies. Representative Charles Rangel, D - New York, who is expected to become chair of the tax writing House Ways and Means Committee, has indicated the Committee will tackle AMT reform. Senator Max Baucus, D - Montana, who will likely become chair of the powerful Senate Finance Committee, has also expressed his support for AMT relief.

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