DESCRIPTION OF THE TAX PROVISIONS IN H.R. 2776, THE "RENEWABLE ENERGY AND ENERGY CONSERVATION TAX ACT OF 2007"

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on June 20, 2007. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the tax provisions in H.R. 2776, the "Renewable Energy and Energy Conservation Tax Act of 2007."

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Tax Provisions in H.R. 2776, the "Renewable Energy and Energy Conservation Tax Act of 2007,"* (JCX-35-07), June 19, 2007. This document can also be found on the web at www.house.gov/jct.

I. PRODUCTION INCENTIVES

A. Extension and Modification of the Credit for the Production of Electricity from Renewable Resources

Present Law

In general

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.[2] Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

Credit amounts and credit period

In general

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

Credit phaseout

The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. The electricity production credit is reduced over a 3 cent phaseout range to the extent the annual average contract price per kilowatt-hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation; 10.7 cents for 2007).

Reduced credit periods and credit amounts

Generally, in the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities placed in service before August 8, 2005, the 10-year credit period is reduced to five years commencing on the date the facility was originally placed in service. However, for qualified open-loop biomass facilities (other than a facility described in sec. 45(d)(3)(A)(i) that uses agricultural livestock waste

[2] Sec. 45. In addition to the electricity production credit, section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

nutrients) placed in service before October 22, 2004, the five-year period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

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

Other limitations on credit claimants and credit amounts

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

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

The credit for electricity produced from renewable sources is a component of the general business credit.[3] Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or so much of the net regular tax liability as exceeds $25,000. Excess credits may be carried back one year and forward up to 20 years.

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

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

Qualified facilities

Wind energy facility

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

Closed-loop biomass facility

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

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

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

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

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimmings; or
- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

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

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

Geothermal facility

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

Solar facility

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

Small irrigation facility

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

Landfill gas facility

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

Trash combustion facility

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

Hydropower facility

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

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

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

Summary of credit rate and credit period by facility type

Table 1.–Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources

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

[1] In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.

[2] For certain facilities placed in service before October 22, 2004, the 5-year credit period commences on January 1, 2005.

Taxation of cooperatives and their patrons

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception: the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, a cooperative that is subject to the cooperative tax rules of subchapter T of the Code[4] is permitted a deduction for patronage dividends paid only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[5] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits

[4] Secs. 1381-1383.

[5] Sec. 1382.

derived from transactions with patrons who are members of the cooperative. For taxable years ending on or before August 8, 2005, cooperatives may not pass any portion of the income tax credit for electricity production through to their patrons.

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

Description of Proposal

The proposal extends and modifies the electricity production credit.

Extension of placed-in-service date for qualifying facilities

The proposal extends for four years (through 2012) the period during which qualified facilities producing electricity from wind, closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste, and qualified hydropower may be placed in service for purposes of the electricity production credit.

Addition of marine and hydrokinetic renewable energy as a qualified resource

The proposal adds marine and hydrokinetic renewable energy as a qualified energy resource and marine and hydrokinetic renewable energy facilities as qualified facilities. Marine and hydrokinetic renewable energy is defined as energy derived from (1) waves, tides, and currents in oceans, estuaries, and tidal areas; (2) free flowing water in rivers, lakes, and streams; (3) free flowing water in an irrigation system, canal, or other man-made channel, including projects that utilize nonmechanical structures to accelerate the flow of water for electric power production purposes; or (4) differentials in ocean temperature (ocean thermal energy conversion). The term does not include energy derived from any source that uses a dam, diversionary structure (except for irrigation systems, canals, and other man-made channels), or impoundment for electric power production. A marine and hydrokinetic renewable energy facility is any facility owned by the taxpayer and placed in service after the date of enactment and before 2014 that produces electric power from marine and hydrokinetic renewable energy and that has a nameplate capacity rating of at least 150 kilowatts.

Under the proposal, marine and hydrokinetic renewable energy facilities subsume small irrigation power facilities. The proposal, therefore, terminates as a separate category of qualified facility small irrigation power facilities placed in service on or after the date of enactment. Such facilities qualify for the electricity production credit as marine and hydrokinetic renewable energy facilities.

Phaseout replaced by limitation based on investment in facility

The proposal replaces the electricity production credit phaseout with an annual limit on the total credits that may be claimed with respect to any qualified facility placed in service after 2008 based on the investment in the facility. Under the limitation, the electricity production credit determined for any taxable year may not exceed the eligible basis of the facility multiplied by a limitation percentage (the "applicable percentage") determined by the Secretary for the month during which the facility is originally placed in service. The applicable percentage for any month is the percentage that yields over a 10-year period amounts of limitation that have a present value equal to 35 percent of the eligible basis of the facility. The discount rate for purposes of this calculation is the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month preceding the month for which the percentage is being prescribed. The eligible basis of a facility is the basis of such facility at the time it is originally placed in service.

Special rules apply for the first and last year of a facility's 10-year credit period to allocate the limitation across a taxpayer's taxable years. In addition, if a facility's production is less than the limitation amount for any taxable year, the limitation with respect to such facility for the next taxable year is increased by the amount of the unused limitation. Similarly, if the electricity production credit exceeds the limitation amount for any taxable year, but falls under the limit the following year, the credit for the following taxable year is increased, up to that year's limitation amount, by the amount of such excess, but not beyond the facility's 10-year credit eligibility period.

Effective Date

The extension of the electricity production credit and the limitation based on investment are effective for facilities originally placed in service after 2008. The repeal of the credit phaseout adjustment is effective for taxable years ending after 2008. The addition of marine and hydrokinetic renewable energy as a qualified energy resource is effective for electricity produced at qualified facilities and sold after the date of enactment in taxable years ending after such date.

B. Extension and Modification of Energy Credit

Present Law

In general

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

The energy credit is a component of the general business credit[6] and as such is subject to the alternative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years.[7] The taxpayer's basis in the property is reduced by the amount of the credit claimed. For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. Similarly, the credit only applies to expenditures made after the effective date of the provision.

In general, property that is public utility property is not eligible for the credit. Public utility property is property that is used predominantly in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, domestic telegraph services, or other communication services (other than international telegraph services), if the rates for such furnishing or sale have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission. This rule is waived in the case of telecommunication companies' purchases of fuel cell and microturbine property.

Special rules for solar energy property

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

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

[7] Sec. 39.

Fuel cells and microturbines

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

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

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

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

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

Description of Proposal

The proposal extends the 30-percent credit for solar and fuel cell property for eight years. Additionally, the fuel cell credit cap of $500 for each 0.5 kilowatt of capacity is raised to $1,500 for each 0.5 kilowatt. The proposal makes the energy credit allowable against the alternative minimum tax.

Also, the restrictions on public utility property being eligible for the credit are eliminated.

Effective Date

The proposal extending the 30-percent credit is effective on the date of enactment. The increase in the credit cap for fuel cells and the proposal relating to the restrictions on public utility property apply to periods after the date of enactment, in taxable years ending after such date, under rules similar to the rules of section 48(m) of the Code (as in effect on the day before the enactment of the Revenue Reconciliation Act of 1990). The allowance of the credit against the alternative minimum tax is effective for credits determined in taxable years beginning after the date of enactment.

C. New Clean Renewable Energy Bonds

Present law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of electric power facilities (i.e., generation, transmission, distribution, and retailing).

Interest on State or local government bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception is contained in the Code (or in non-Code provision of a revenue Act). The term "private person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater.

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[8] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[9] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt.[10] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

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[8] Sec. 103(a) and (b)(2).

[9] Sec. 148.

[10] Sec. 149(e).

Clean renewable energy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[11] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. The discount rate used to determine the present value amount is the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the CREBs are issued. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding.

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

In addition to the above requirements, at least 95 percent of the proceeds of CREBs must be spent on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the

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

five-year spending period, bonds will continue to qualify as CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem bonds. The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

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

Description of Proposal

The proposal creates a new category of clean renewable energy bonds ("New CREBs") that may be issued by qualified issuers to finance qualified renewable energy facilities. Qualified renewable energy facilities are facilities: (1) that qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) that are owned by a public power provider or cooperative electric company. The term "cooperative electric company" means a mutual or cooperative electric company (described in section 501(c)(12) or section 1381(a)(2)(C)). The term "public power provider" means a State utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act (as in effect on the date of the enactment of this paragraph). The term "qualified issuers" includes: (1) public power providers; (2) cooperative electric companies; (3) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (4) clean renewable energy bond lenders. A clean renewable energy bond lender means a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

There is a national limitation for New CREBs of $2 billion. The proposal limits the total allocations that may be made to projects of public power providers and projects of cooperative electric companies to 60 percent of the national limitation and 40 percent of the national limitation, respectively. Allocations to cooperative electric companies may be made in the manner the Secretary determines appropriate. Allocations to projects of public power providers shall be made, to the extent practicable, in such manner that the amount allocated to each such project bears the same ratio to the cost of such project as the maximum allocation limitation to projects of public power providers bears to the cost of all such projects.

Under the proposal, 100 percent of the available project proceeds of New CREBs must be used within the three-year period that begins on the date of issuance. The proposal defines available project proceeds as proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as New CREBs if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

New CREBs generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner such that the fund will not exceed the amount necessary to repay the issue if invested at the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the New CREBs are issued; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the New CREBs are issued.

The maturity of New CREBs is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the qualified energy conservation bonds are issued.

As with present-law CREBs, the taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. The credit rate is determined by the Secretary to be a rate that permits issuance of the bonds without discount and interest cost to the issuer. The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unlike present-law CREBs, however, the credit rate on New CREBs is determined by the Secretary and is to be a rate that is 70 percent of the rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Effective Date

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

D. Extension and Modification of Special Rule for Sales or Other Dispositions to Implement FERC Restructuring Policy or State Electric Restructuring Policy

Present Law

Generally, a taxpayer selling property recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[12] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2008. In general, an independent transmission company is defined as: (1) an independent transmission provider[13] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than December 31, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

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[12] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

[13] For example, a regional transmission organization, an independent system operator, or an independent transmission company.

Description of Proposal

The proposal extends the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility prior to January 1, 2010. A qualified electric utility is defined as an electric utility as defined in the Federal Power Act[14] and any person in the same holding company system[15] as an electric utility.

The definition of an independent transmission company is modified for taxpayers whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider, which under the proposal must take place no later than four years after the close of the taxable year in which the transaction occurs.

The proposal also changes the definition of exempt utility property to exclude property that is located outside the United States.

Effective Date

The extension proposal applies to qualifying electric transmission transactions after December 31, 2007. The change in the definition of an independent transmission company is effective as if included in section 909 of the American Jobs Creation Act of 2004. The exception for property located outside the United States applies to qualifying electric transmission transactions after the date of enactment.

[14] Sec. 3(22), 16 U.S.C. 796(22).

[15] Sec. 1262(9) of the Public Utility Holding Company Act of 2005, 42 U.S.C. 16451(9).

E. Credit for Residential Energy Efficient Property

Code section 25D provides a personal tax credit for the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of $2,000. Section 25D also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified solar electric property is property that uses solar energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

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

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

The credit is not allowed against the alternative minimum tax.

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

Description of Proposal

The proposal eliminates the fuel cell credit cap of $500 for each 0.5 kilowatt of capacity and the $2,000 solar electric and $2,000 solar water heating caps. The proposal also allows the credit to offset alternative minimum tax liability.

Effective Date

The proposal is generally effective for expenditures after the date of enactment. The allowance of the credit against the alternative minimum tax is effective for taxable years beginning after the date of enactment.

II. CONSERVATION

A. Transportation

1. Plug-in hybrid vehicle credit and modification of the alternative motor vehicle credit

Present Law

In general

A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year.[16] In general, the credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005. The credit terminates after 2009, 2010, or 2014, depending on the type of vehicle.

In general, the credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease. If the use of the vehicle is described in paragraphs (3) or (4) of section 50(b) (relating to use by tax-exempt organizations, governments, and foreign persons) and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

Fuel cell vehicles

A qualified fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored on board the vehicle and may or may not require reformation prior to use. A qualified fuel cell vehicle must be purchased before January 1, 2015. The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes.[17] Table 2, below, shows the base credit amounts.

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[16] Sec. 30B.

[17] See discussion surrounding Table 7, below.

Table 2.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating (pounds)	Credit Amount
Vehicle ≤ 8,500	$8,000
8,500 < vehicle ≤ 14,000...................................	$10,000
14,000 < vehicle ≤ 26,000.................................	$20,000
26,000 < vehicle..	$40,000

In the case of a fuel cell vehicle weighing less than 8,500 pounds and placed in service after December 31, 2009, the $8,000 amount in Table 2, above is reduced to $4,000.

Table 3, below, shows the additional credits for passenger automobiles or light trucks.

Table 3.–Credit for Qualified Fuel Cell Vehicles

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	at least	but less than
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	275% of base fuel economy
$3,500	275% of base fuel economy	300% of base fuel economy
$4,000	300% of base fuel economy	

Hybrid vehicles and advanced lean burn technology vehicles

Qualified hybrid vehicle

A qualified hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy that include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualified hybrid vehicle must be placed in service before January 1, 2011 (January 1, 2010 in the case of a hybrid vehicle weighing more than 8,500 pounds).

Hybrid vehicles that are automobiles and light trucks

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard and (2) a conservation credit based on the estimated lifetime fuel savings of the qualified vehicle compared to a comparable 2002 model year vehicle that is powered solely by a gasoline or diesel internal combustion engine. A qualified hybrid automobile or light truck must have a maximum available power[18] from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain Environmental Protection Agency ("EPA") emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 4, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy.

Table 4.–Fuel Economy Credit

	If Fuel Economy of the Hybrid Vehicle Is:	
Credit	**at least**	**but less than**
$400	125% of base fuel economy	150% of base fuel economy
$800	150% of base fuel economy	175% of base fuel economy
$1,200	175% of base fuel economy	200% of base fuel economy
$1,600	200% of base fuel economy	225% of base fuel economy
$2,000	225% of base fuel economy	250% of base fuel economy
$2,400	250% of base fuel economy	

Table 5, below, shows the conservation credit.

[18] For hybrid passenger vehicles and light trucks, the term "maximum available power" means the maximum power available from the rechargeable energy storage system, during a standard 10 second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine. Sec. 30B(d)(3)(C)(i).

Table 5.–Conservation Credit

Estimated Lifetime Fuel Savings (gallons of gasoline)	Conservation Amount
At least 1,200 but less than 1,800	$250
At least 1,800 but less than 2,400	$500
At least 2,400 but less than 3,000	$750
At least 3,000	$1,000

Advanced lean burn technology vehicles

The amount of credit for the purchase of an advanced lean burn technology vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard as described in Table 4, above, and (2) a conservation credit based on the estimated lifetime fuel savings of a qualified vehicle compared to a comparable 2002 model year vehicle as described in Table 5, above. The amounts of the credits are determined after an adjustment is made to account for the different BTU content of gasoline and the fuel utilized by the lean burn technology vehicle.

A qualified advanced lean burn technology vehicle is a passenger automobile or a light truck that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and for 2004 and later model vehicles meets or exceeds certain Environmental Protection Agency emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. A qualified advanced lean burn technology vehicle must be placed in service before January 1, 2011.Limitation on number of qualified hybrid and advanced lean burn technology vehicles eligible for the credit

There is a limitation on the number of qualified hybrid vehicles and advanced lean burn technology vehicles sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean burn technology vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

Thus, for example, summing the sales of qualified hybrid vehicles of all weight classes and all sales of qualified advanced lean burn technology vehicles, if a manufacturer records the sale of its 60,000th qualified vehicle in February of 2007, taxpayers purchasing such vehicles from the manufacturer may claim the full amount of the credit on their purchases of qualified vehicles through June 30, 2007. For the period July 1, 2007, through December 31, 2007, taxpayers may claim one half of the otherwise allowable credit on purchases of qualified vehicles of the manufacturer. For the period January 1, 2008, through June 30, 2008, taxpayers may claim one quarter of the otherwise allowable credit on the purchases of qualified vehicles of the manufacturer. After June 30, 2008, no credit may be claimed for purchases of hybrid vehicles or advanced lean burn technology vehicles sold by the manufacturer.

Hybrid vehicles that are medium and heavy trucks

In the case of a qualified hybrid vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle compared to a comparable vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use of the vehicle. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is $7,500. For a qualified hybrid vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is $15,000. For a qualified hybrid vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is $30,000.

A qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualified hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.[19]

Alternative fuel vehicle

The credit for the purchase of a new alternative fuel vehicle is 50 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards. The incremental cost of any new qualified alternative fuel vehicle is the excess of the manufacturer's suggested retail price for such vehicle over the price for a gasoline

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[19] In the case of such heavy-duty hybrid motor vehicles, the percentage of maximum available power is computed by dividing the maximum power available from the rechargeable energy storage system during a standard 10-second pulse power test, divided by the vehicle's total traction power. A vehicle's total traction power is the sum of the peak power from the rechargeable energy storage system and the heat (e.g., internal combustion or diesel) engine's peak power. If the rechargeable energy storage system is the sole means by which the vehicle can be driven, then the total traction power is the peak power of the rechargeable energy storage system.

or diesel fuel vehicle of the same model. To be eligible for the credit, a qualified alternative fuel vehicle must be purchased before January 1, 2011.

The amount of the credit varies depending on the weight of the qualified vehicle. The credit is subject to certain maximum applicable incremental cost amounts. Table 6, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class as well as the maximum credit amount for such vehicles.

Table 6.–Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating (pounds)	Maximum Allowable Incremental Cost	Maximum Allowable Credit
Vehicle ≤ 8,500	$5,000	$4,000
8,500 < vehicle ≤ 14,000..................................	$10,000	$8,000
14,000 < vehicle ≤ 26,000................................	$25,000	$20,000
26,000 < vehicle..	$40,000	$32,000

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualified alternative fuel vehicles are vehicles that operate only on qualified alternative fuels and are incapable of operating on gasoline or diesel (except to the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

Certain mixed fuel vehicles, that is vehicles that use a combination of an alternative fuel and a petroleum-based fuel, are eligible for a reduced credit. If the vehicle operates on a mixed fuel that is at least 75 percent alternative fuel, the vehicle is eligible for 70 percent of the otherwise allowable alternative fuel vehicle credit. If the vehicle operates on a mixed fuel that is at least 90 percent alternative fuel, the vehicle is eligible for 90 percent of the otherwise allowable alternative fuel vehicle credit.

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy by vehicle type and vehicle inertia weight class. For this purpose, "vehicle inertia weight class" has the same meaning as when defined in regulations prescribed by the EPA for purposes of Title II of the Clean Air Act. Table 7, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

Table 7.–2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Other rules

The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as a portion of the general business credit; the remainder of the credit is allowable to the extent of the excess of the regular tax (reduced by certain other credits) over the alternative minimum tax for the taxable year.

Description of Proposal

Plug-in hybrid credit

The proposal allows a credit for each qualified plug-in hybrid vehicle placed in service. The base amount of the credit is $4,000. If the qualified vehicle draws propulsion from a battery with at least 5 kilowatt-hours of capacity, the credit amount is increased by $200, plus another $200 for each kilowatt-hour of battery capacity in excess of 5 kilowatt-hours, up to a maximum additional credit of $2,000.

In general, the credit is available to the vehicle owner, including the lessor of a vehicle subject to lease. If the qualified vehicle is used by certain tax-exempt organizations, governments, or foreign persons and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

A qualified plug-in hybrid vehicle is a motor vehicle that meets certain emissions standards and is propelled to a significant extent by an electric motor that draws electricity from a battery that (1) has a capacity of at least 4 kilowatt-hours; (2) is capable of being recharged from an external source of electricity; and (3) is also propelled to a significant extent by other than an electric motor or has a significant onboard source of electricity that also recharges the battery. Qualified vehicles must have a gross weight of less than 14,000 pounds. In addition, qualified vehicles weighing less than 8,500 pounds must be passenger automobiles or light trucks.

There is a limitation on the number of qualified plug-in hybrid vehicles sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th plug-in hybrid vehicle sale. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

The basis of any qualified vehicle is reduced by the amount of the credit. To the extent a vehicle is eligible for credit as a qualified plug-in hybrid vehicle, it is not eligible for credit as a qualified hybrid vehicle under section 30B. The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as part of the general business credit; the nonbusiness portion of the credit is allowable to the extent of the excess of the regular tax and the alternative minimum tax (reduced by certain other credits) for the taxable year.

<u>Treatment of alternative motor vehicle credit as a personal credit</u>

The proposal modifies the section 30B alternative motor vehicle credit by treating the nonbusiness portion of that credit as a personal credit. As a result, in the event Congress in the future extends the provision allowing personal credits to offset the alternative minimum tax, the alternative motor vehicle credit will be allowable against the alternative minimum tax.

Effective Date

The plug-in hybrid credit proposal is effective for taxable years beginning after December 31, 2007. The proposal treating the nonbusiness portion of the alternative motor vehicle credit as a personal credit is effective for taxable years beginning after December 31, 2006.

2. Extension and modification of the alternative fuel refueling property credit

Present Law

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.[20] The credit may not exceed $30,000 per taxable year, per location, in the case of qualified refueling property used in a trade or business and $1,000 per taxable year per location in the case of qualified refueling property installed on property which is used as a principal residence.

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

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

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for 1 year and forward for 20 years. Credits for residential qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

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

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

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[20] Sec. 30C.

Description of Proposal

The proposal extends and modifies the credit for installing alternative fuel refueling property. The proposal extends for one year (through 2010) the credit for installing non-hydrogen alternative fuel refueling property. The proposal also increases the credit amount to 50 percent of the cost of the qualified property and raises to $50,000 per taxable year, per location, the limit with respect to depreciable qualified property.

Effective Date

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

3. Extension of credits for biodiesel and extension and modification of renewable diesel credit

Present Law

Income tax credit

Overview

The Code provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[21] The biodiesel fuels credit is the sum of the biodiesel mixture credit, the biodiesel credit and the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2008.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

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

[21] Sec. 40A.

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel (other than agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is $1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

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

Small agri-biodiesel producer credit

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

Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.[22] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is $1.00 per gallon. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[23]

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[22] Sec. 6426(c).

[23] Sec. 6426(c)(4).

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

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[24] To the extent the biodiesel fuel mixture credit exceeds the section 4081 liability of a person, the Secretary is to pay such person an amount equal to the biodiesel fuel mixture credit with respect to such mixture.[25] Thus, if the person has no section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2008.

Renewable diesel

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

For purposes of the Code, renewable diesel is generally treated the same as biodiesel Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[26] The incentive for renewable diesel is $1.00 per gallon and there is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2008.

Description of Proposal

The proposal extends an additional two years (through December 31, 2010) the income tax credit, excise tax credit, and payment provisions for biodiesel (including agri-biodiesel) and renewable diesel.

The proposal modifies the definition of renewable diesel to eliminate the requirement that the fuel be made using a thermal depolymerization process. The proposal also requires that all renewable diesel meet the ASTM D975 standard by eliminating the ASTM D396 standard from the definition of renewable diesel.

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[24] Sec. 6427(e).

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

[26] Secs. 40A(f), 6426(c), and 6427(e).

Effective Date

The proposal is generally effective for fuel produced, and sold or used, after the date of enactment. The modifications to the definition of renewable diesel are effective for fuel produced, and sold or used, after the date that is 30 days after the date of enactment.

4. Credit for production of cellulosic alcohol

Present Law

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2010.[27]

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

Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). For alcohol other than ethanol, the rate is 60 cents per gallon.[28]

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

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

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

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

Description of Proposal

The proposal adds a fourth component to the alcohol fuels credit. The proposal provides an income tax credit of 50 cents per gallon for certain qualified cellulosic fuel production of the producer for the taxable year. Qualified cellulosic fuel production is any cellulosic alcohol that is produced by a cellulosic alcohol fuel producer during the taxable year and is (1) sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such alcohol at retail to another person and places such alcohol in the fuel tank of such other person; or (2) is used by the producer for any purpose described in (1)(a), (b), or (c).

Cellulosic alcohol is alcohol that (1) is produced in the United States for consumption in the United States and (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. Examples of such lignocellulosic or hemicellulosic matter include dedicated energy crops and trees, wood and wood residues, plants, grasses, agricultural residues, fibers, animal wastes and other waste materials, and municipal solid waste.

"Cellulosic alcohol fuel producer" means any person who produces cellulosic alcohol in a trade or business and is registered with the Secretary as a cellulosic alcohol fuel producer.

Effective Date

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

5. Bicycle commuting reimbursement fringe benefit

Present Law

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income.[29] Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits. Up to $215 (for 2007) per month of employer-provided parking is excludable from income. Up to $110 (for 2007) per month of employer-provided transit and vanpool benefits are excludable from gross income. These amounts are indexed annually for inflation, rounded to the nearest multiple of $5.

Under present law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is

[29] Code sec. 132(f).

considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Description of Proposal

The proposal adds a qualified bicycle commuting reimbursement fringe benefit as a qualified transportation fringe benefit. A qualified bicycle commuting reimbursement fringe benefit means, with respect to a calendar year, any employer reimbursement during the 15-month period beginning with the first day of such calendar year of an employee for reasonable expenses incurred by the employee during the calendar year for the purchase and repair of a bicycle, bicycle improvements, and bicycle storage, provided that the bicycle is regularly used for travel between the employee's residence and place of employment.

The maximum amount that can be excluded from an employee's gross income for a calendar year on account of a bicycle commuting reimbursement fringe benefit is the applicable annual limitation for the employee for that calendar year. The applicable annual limitation for an employee for a calendar year is equal to the product of $20 multiplied by the number of the employee's qualified bicycle commuting months for the year. The $20 amount is not indexed for inflation. A qualified bicycle commuting month means with respect to an employee any month for which the employee does not receive any other qualified transportation fringe benefit and during which the employee regularly uses a bicycle for a substantial portion of travel between the employee's residence and place of employment. Thus, no amount is credited towards an employee's applicable annual limitation for any month in which an employee's usage of a bicycle is infrequent or constitutes an insubstantial portion of the employee's commute.

A bicycle commuting reimbursement fringe benefit cannot be funded by an elective salary contribution on the part of an employee.

Effective Date

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

6. Modification of the limitation on depreciation under section 280F

Present Law

Limitation on depreciation

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, passenger automobiles generally are recovered over a recovery period of five years. However, section 280F imposes a limitation on the amount of the annual depreciation deduction for passenger automobiles, including certain trucks and vans.

For passenger automobiles subject to the limitation and placed in service in 2007, the maximum amount of allowable depreciation is $3,060 for the year in which the vehicle is placed in service, $4,900 for the second year, $2,850 for the third year, and $1,775 for the fourth and later years. For trucks and vans subject to the limitation and placed in service in 2007, the maximum amount of allowable depreciation is $3,260 for the year in which the vehicle was placed in service, $5,200 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years. The limitation applies to the combined amount of the depreciation deduction and the section 179 expensing otherwise permitted under present law for the vehicle.

For purposes of the limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[30] In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sport utility vehicles under this weight amount are generally treated as a truck for the purpose of applying the limitation.[31]

Limitation on expensing

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. The Small Business and Work Opportunity Tax Act of 2007[32] increased the amount a taxpayer may deduct, for taxable years beginning in 2007 through 2010, to $125,000 of the cost of qualifying property placed in service for the taxable year.[33] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2010 is treated as qualifying property. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after 2007 and before 2011.[34]

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[30] Sec. 280F(d)(5)(A). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

[31] Rev. Proc. 2007-30, 2007-18 I.R.B. 1104.

[32] Pub. L. No. 110-28, sec. 8212 (2007).

[33] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[34] For taxable years beginning in 2011 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation.

Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F. The limitation applies to the combined amount of the depreciation deduction and the section 179 expensing for the taxable year otherwise permitted under present law for the vehicle.

For sport utility vehicles above the 6,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is $25,000.[35] For purposes of this provision, a sport utility vehicle is defined as any 4-wheeled vehicle which: (1) is primarily designed or which can be used to carry passengers over public streets, roads, or highways; (2) is not subject to the section 280F limitations; and (3) is rated at not more than 14,000 pounds gross vehicle weight. Certain vehicles are excluded from this limitation, including any vehicle which: (1) is designed to have a seating capacity of more than nine persons behind the driver's seat; (2) is equipped with a cargo area of at least six feet in interior length which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Description of Proposal

The proposal modifies the definition of passenger automobiles subject to the section 280F limitation on depreciation and expensing. Under the proposal, passenger automobiles are defined to include any 4-wheeled vehicles that are designed primarily to carry passengers over public streets, roads, or highways and which are rated at 14,000 pounds gross vehicle weight or less. Thus, under the proposal, sport utility vehicles with a gross vehicle weight over 6,000 through 14,000 pounds (as well as those rated at 6,000 pounds or less gross vehicle weight) generally are subject to the section 280F limitation on depreciation and expensing.

The proposal contains two categories of excepted vehicles: exempt-design vehicles and exempt-use vehicles. Some of the exceptions included within these two categories are included in present law, but some of the exceptions are new under the proposal. An exempt-design vehicle is any vehicle: (1) which, by reason of its nature or design, is not likely to be used more than a de minimis amount for personal purposes;[36] (2) which is designed to have a seating capacity of more than nine persons behind the driver's seat; (3) which is equipped with a cargo area of at least five feet in interior length, which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or (4) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield. An exempt-use

[35] Sec. 179(b)(6).

[36] Examples of such vehicles include qualified nonpersonal use vehicles as defined in Treas. Reg. sec. 1.274-5T(k).

vehicle is: (1) any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business; (2) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire; or (3) any truck or van if substantially all of the use of such vehicle by the taxpayer is directly in (a) a farming business, (b) the transportation of a substantial amount of equipment, supplies, or inventory, or (c) the moving or delivery of property which requires substantial cargo capacity.

The proposal imposes a recapture requirement in the case of any vehicle that is not a passenger automobile by reason of being an exempt-use vehicle to the extent the vehicle ceases to be an exempt-use vehicle in any taxable year after the taxable year in which the vehicle is placed in service. The proposal also repeals the separate rule in present-law section 179(b)(6) relating to expensing of sport utility vehicles.

Effective Date

The proposal is effective for property placed in service after December 31, 2007.

7. Restructure New York Liberty Zone tax incentives

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[37]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.[38] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

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[37] In addition to the NYLZ provisions described above, other NYLZ incentives are provided: (1) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property is authorized to be issued after March 9, 2002, and before January 1, 2010; and (2) $9 billion of additional tax-exempt advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

[38] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[39] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property[40] and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[41] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.[42]

Nonresidential real property and residential rental property are eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the

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[39] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

[40] Qualified NYLZ leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as "qualified NYLZ leasehold improvement property" may be eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

[41] For purposes of this provision, purchase is defined as under section 179(d).

[42] Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

property is placed in service on or before December 31, 2006[43] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Depreciation of New York Liberty Zone leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[44] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[45] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.[46]

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001, and before January 1, 2007 (and not subject to a binding contract on September 10, 2001), in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a nine-year recovery period. A taxpayer may elect out of the 5-year (and 9-year) recovery period for qualified NYLZ leasehold improvement property.

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[43] December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

[44] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[45] Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

[46] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp. Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

Increased section 179 expensing for qualified New York Liberty Zone property

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. The Small Business and Work Opportunity Tax Act of 2007[47] increased the amount a taxpayer may deduct, for taxable years beginning in 2007 through 2010, to $125,000 of the cost of qualifying property placed in service for the taxable year.[48] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2010 is treated as qualifying property. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after 2007 and before 2011.[49] In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased by the lesser of (1) $35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property for purposes of the NYLZ provision means section 179 property[50] purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct

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[47] Pub. L. No. 110-28, sec. 8212 (2007).

[48] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[49] For taxable years beginning in 2011 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed for inflation.

[50] As defined in sec. 179(d)(1).

of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.[51]

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The provision is effective for property placed in service after September 10, 2001 and before January 1, 2007.

Extended replacement period for New York Liberty Zone involuntary conversions

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use.[52] If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[53] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[54]

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in the city of New York. In all other cases, the present-law replacement period rules continue to apply.

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[51] See Rev. Proc. 2002-33, 2002-1 C.B. 963 (May 20, 2002), for procedures on claiming the increased section 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

[52] Sec. 1033(a).

[53] Sec. 1033(a)(2)(B).

[54] Sec. 1033(g)(4).

Description of Proposal

Repeal of certain NYLZ incentives

The proposal repeals the first-year depreciation allowance of 30 percent and the additional section 179 expensing in the case of nonresidential real property and residential rental property as of the date of enactment of this proposal.[55]

Creation of New York Liberty Zone Tax Credits

The proposal provides a credit against tax imposed for any payroll period by section 3402 (related to withholding for wages paid) for which a New York Liberty Zone governmental unit is liable under section 3403. The credit is equal to such portion of the qualifying project expenditure amounts allocated to the governmental unit for the calendar year that such governmental unit allocates to such period. The amount of the credit allowed for any payroll period shall be treated as a payment to the Secretary on the day on which the wages were paid to the employee, but only to the extent the governmental unit actually deducted and withheld such wages for the applicable period. A New York Liberty Zone governmental unit is the State of New York, the City of New York, or any agency or instrumentality of such State or city.

Qualifying project expenditure amount means, with respect to any calendar year, the sum of (1) the total expenditures paid or incurred during such calendar year by all New York Liberty Zone governmental units and the Port Authority of New York and New Jersey for any portion of qualifying projects located wholly within the City of New York, and (2) any such expenditures paid or incurred in any preceding calendar year beginning after the date of enactment of this proposal and not previously allocated.

A qualifying project is any transportation infrastructure project, including highways, mass transit systems, railroads, airports, ports, and waterways, in or connecting with the New York Liberty Zone, which is designated as a qualifying project by the Governor of the State of New York and the Mayor of the City of New York.

The Governor of the State of New York and the Mayor of the City of New York are to jointly allocate to each New York Liberty Zone governmental unit the portion of the qualifying expenditure amount that may be taken into account by such governmental unit to determine the credit for any calendar year in the credit period. The credit period is the 12-year period beginning on January 1, 2008. Aggregate amounts allocated may not exceed $2 billion during the credit period. There is also an annual limit on allocations equal to (1) $169 million for each year of the credit period, plus (2) any amounts in (1) that were authorized to be allocated for prior calendar years in the credit period but not so allocated.

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[55] In the case of nonresidential real property and residential rental property acquired pursuant to a binding contract in effect on such enactment date, the first-year depreciation allowance of 30 percent and the additional section 179 expensing provisions terminate on December 31, 2009.

If amounts allocated to a New York Liberty Zone governmental unit exceed the aggregate taxes for which such unit is liable under section 3403, the excess may be carried to the succeeding calendar year and added to the allocation for that calendar year. If a New York Liberty Zone governmental unit does not use an amount allocated to it within the time prescribed by the Governor of the State of New York and the Mayor of the City of New York, such amounts will be treated as if never allocated, and thus they may be reallocated by the Governor and Mayor.

Under the proposal, any expenditure for a qualifying project taken into account for purposes of the credit shall be considered State and local funds for the purpose of any Federal program.

The Governor of the State of New York and the Mayor of the City of New York must jointly submit to the Secretary an annual report that certifies the qualifying project expenditure amounts for the calendar year, the amount allocated to each New York Liberty Zone governmental unit, and any other such information as the Secretary may require.

Effective Date

The proposal is effective on the date of enactment.

B. Other Conservation Provisions

1. Qualified energy conservation bonds

Present law

Tax-exempt bonds

In general

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

Private activity bond tests

Present law provides two tests for determining whether a State or local bond is in substance a private activity bond, the private business test and the private loan test.[56]

Private business tests

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied–

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and

2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").[57]

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[56] Sec. 141(b) and (c).

[57] The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. In addition, as described more fully below, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain "output" facilities. The term output facility includes electric generation, transmission, and distribution facilities.

Private business use generally includes any use by a business entity (including the Federal government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.[58]

Private loan test

The second standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond (sec. 141(e)). The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater.

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[58] See Treas. Reg. sec. 1.141-3(b)(4) and Rev. Proc. 97-13, 1997-1 C.B. 632.

Arbitrage restrictions

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[59] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[60] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Indian tribal governments

Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.[61] Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.[62]

Clean renewable energy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[63] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal

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[59] Sec. 103(a) and (b)(2).

[60] Sec. 148.

[61] Sec. 7871.

[62] Sec. 7871(c).

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

government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding.

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

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

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

Description of Proposal

The proposal creates a new category of tax-credit bonds, qualified energy conservation bonds. Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term "qualified conservation purpose" means:

1. Capital expenditures incurred for purposes of reducing energy consumption in publicly owned buildings by at least 20 percent or implementing green community programs;

2. Expenditures with respect to facilities or grants that support research in: (A) development of cellulosic ethanol or other nonfossil fuels; (B) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (C) increasing the efficiency of existing technologies for producing nonfossil fuels; (D) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (E) technologies to reduce energy use in buildings;

3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

4. Demonstration projects designed to promote the commercialization of: (A) green building technology; (B) conversion of biomass into methane to be used in producing fuel or otherwise; (C) advanced battery manufacturing technologies; (D) technologies to reduce peak-use of electricity; and (D) technologies for the capture and sequestration of carbon dioxide; and

5. Public education campaigns to promote energy efficiency.

There is a national limitation on qualified energy conservation bonds of $3.6 billion. Allocations of qualified energy conservation bonds are made to the States with sub-allocations to large local governments. Allocations are made to the States according to their respective populations, reduced by any sub-allocations to large local governments (defined below) within the States. Sub-allocations to large local governments shall be an amount of the national qualified energy conservation bond limitation that bears the same ratio to the amount of such limitation that otherwise would be allocated to the State in which such large local government is located as the population of such large local government bears to the population of such State. The term large local government means: any municipality or county if such municipality or county has a population of 100,000 or more. Indian tribal governments also are treated as large local governments for these purposes (without regard to population).

Each State or large local government receiving an allocation of qualified energy conservation bonds may further allocate issuance authority to issuers within such State or large local government. However, any allocations to issuers within the State or large local government shall be made in a manner that results in not less than 70 percent of the allocation of qualified energy conservation bonds to such State or large local government being used to designate bonds that are not private activity bonds (i.e., the bond cannot meet the private business tests or the private loan test of section 141).

Under the proposal, 100 percent of the available project proceeds of qualified energy conservation bonds must be used for qualified conservation purposes. In the case of qualified conservation bonds issued as private activity bonds, 100 percent of the available project proceeds must be used for capital expenditures. In addition, qualified energy conservation bonds only may be issued by Indian tribal governments to the extent such bonds are issued for purposes that satisfy the present law requirements for tax-exempt bonds issued by Indian tribal governments (i.e., essential governmental functions and certain manufacturing purposes).

The proposal requires 100 percent of the available project proceeds of qualified energy conservation bonds to be used within the three-year period that begins on the date of issuance. The proposal defines available project proceeds as proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified conservation purposes during the three-year spending period, bonds will continue to qualify as qualified energy conservation bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified energy conservation bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner such that the fund will not exceed the amount necessary to repay the issue if invested at the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

The maturity of qualified energy conservation bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

As with present-law tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is determined by the Secretary to be a rate that permits issuance of the bonds without discount and interest cost to the qualified issuer. The amount of the tax credit to the holder is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits in one year may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Effective Date

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

2. Qualified residential energy efficiency assistance bonds

Present law

Tax-exempt bonds

In general

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

Private activity bond tests

Present law provides two tests for determining whether a State or local bond is in substance a private activity bond, the private business test and the private loan test.[64]

Private business tests

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied--

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and
2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").[65]

Private business use generally includes any use by a business entity (including the Federal government), which occurs pursuant to terms not generally available to the general

[64] Sec. 141(b) and (c).

[65] The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. In addition, as described more fully below, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain "output" facilities. The term output facility includes electric generation, transmission, and distribution facilities.

public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.[66]

Private loan test

The second standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond (sec. 141(e)). The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater.

[66] See Treas. Reg. sec. 1.141-3(b)(4) and Rev. Proc. 97-13, 1997-1 C.B. 632.

Arbitrage restrictions

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[67] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[68] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Clean renewable energy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[69] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

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[67] Sec. 103(a) and (b)(2).

[68] Sec. 148.

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

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding.

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

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

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

Description of Proposal

The proposal creates a new category of tax-credit bonds, qualified residential energy efficiency assistance bonds. A bond is a qualified residential energy efficiency assistance bond if, in addition to the requirements described below, 100 percent of the available project proceeds are used for qualified residential energy efficiency assistance purposes and not less than 20 percent of the available project proceeds are used for qualified low-income residential energy efficiency assistance purposes.

A "qualified residential energy efficiency assistance purpose" is any grant or low-interest loan made by a State to acquire (including reasonable installation costs): (1) any property that meets (at a minimum) the requirements of the Energy Star program and which is to be installed in a dwelling unit; (2) any property that uses wind, solar energy, geothermal energy, or qualified fuel cell property to generate electricity, or to heat or cool water, for use in a dwelling unit (other than property described in section 25D(e)(3)); and (3) any improvements to a dwelling unit that are made pursuant to a plan certified by an energy efficiency expert that such improvements will yield at least a 20 percent reduction in total energy consumption related to heating, cooling, lighting, and appliances. The term "low-interest loan" means any loan that charges interest at a rate that does not exceed the applicable Federal rate in effect under section 1288(b)(1) (relating to original issue discount for tax-exempt obligations).

Generally, grants or loans for improvements to a dwelling unit that are made pursuant to a plan certified by an energy efficiency expert that such improvements will yield at least a 20 percent reduction in total energy consumption may not exceed $5,000, in the aggregate. This amount is increased to $8,000 if such improvements are certified to yield at least a 35 percent reduction in total energy consumption and to $12,000 if such improvements are certified to yield at least a 50 percent reduction in total energy consumption.

A "qualified low-income residential energy efficiency assistance purpose" means any grant for a qualified residential energy efficiency assistance purpose with respect to a dwelling unit that is occupied (at the time of the grant) by individuals whose income is 50 percent or less of area median gross income (as determined under section 142(d)(2)(B)).

The proposal requires 100 percent of available project proceeds to be used within the three-year period that begins on the date of issuance. The proposal defines available project proceeds as proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified residential energy efficiency assistance purposes during the three-year spending period, bonds will continue to qualify as qualified residential energy efficiency assistance bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified residential energy efficiency assistance bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner such that the fund will not exceed the amount necessary to repay the issue if invested at the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified residential energy efficiency assistance bonds are issued; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified residential energy efficiency assistance bonds are issued.

Under the proposal, repayments of principal and applicable interest on financing provided by qualified residential energy efficiency assistance bonds must be used not later than the close of the three-month period beginning on the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue or for additional qualified residential energy efficiency assistance purposes. Applicable interest is interest on any loan that exceeds one percentage point.

The maturity on qualified residential energy efficiency assistance bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified residential energy efficiency assistance bonds are issued.

As with present-law tax-credit bonds, the taxpayer holding qualified residential energy efficiency assistance bonds on a credit allowance date is entitled to a tax credit. The credit rate on qualified residential energy efficiency assistance bonds is determined by the Secretary to be a rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The amount of the tax credit to the holder is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits in one year may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

There is a national limitation for qualified residential energy efficiency assistance bonds of $2.4 billion. Allocations are made to the States according to their respective populations. Qualified issuers of qualified residential energy efficiency assistance bonds include the States (including constituted authorities empowered to issue obligations on behalf of the States).

Effective Date

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

3. Energy efficient commercial buildings deduction

Present Law

In general

Section 179D provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual.

The Secretary shall prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is allowed under this section, the basis of the property shall be reduced by the amount of the deduction.

The deduction is effective for property placed in service after December 31, 2005 and prior to January 1, 2009.

Partial allowance of deduction

In the case of a building that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.60 per square foot for each separate system.

Interim rules for lighting systems

In the case of system-specific partial deductions, in general no deduction is allowed until the Secretary establishes system-specific targets[70]. However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents

[70] IRS Notice 2006-52 has set a target of a 16 2/3 percent reduction in total energy and power costs for each of the three subsystems.

per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions under the interim rule.

Description of Proposal

The proposal extends the energy efficient commercial buildings deduction for five years.

Effective Date

The proposal is effective on the date of enactment.

4. Extension and modification of energy efficient appliance credit

Present Law

The provision provides a credit for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators.

The credit for dishwashers applies to dishwashers produced in 2006 and 2007 that meet the Energy Star standards for 2007. The credit amount equals $3 multiplied by 100 times the "energy savings percentage," but may not exceed $100 per dishwasher. The energy saving percentage is defined as the change in the energy factor (EF) required by the Energy Star program between 2007 and 2005 divide by the EF requirement for 2007. The EF required in 2005 for the Energy Star program was 0.58 and it was 0.65 in 2007, for a change of 0.07. The energy saving percentage is thus 0.07 / 0.65, which when multiplied by 100 times $3 equals $32.31 per refrigerator.

The credit for clothes washers equals $100 for clothes washers manufactured in 2006-2007 that meet the requirements of the Energy Star program that are in effect for clothes washers in 2007.

The credit for refrigerators is based on energy savings and year of manufacture. The energy savings are determined relative to the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. Refrigerators that achieve a 15 to 20 percent energy saving and that are manufactured in 2006 receive a $75 credit. Refrigerators that achieve a 20 to 25 percent energy saving receive a (i) $125 credit if manufactured in 2006-2007. Refrigerators that achieve at least a 25 percent energy saving receive a (i) $175 credit if manufactured in 2006-2007.

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the 3 prior calendar years for each category of appliance. In the case of refrigerators, eligible production is U.S. production that exceeds 110 percent of the average amount of U.S. production from the 3 prior calendar years.

A dishwasher is any a residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

The taxpayer may not claim credits in excess of $75 million for all taxable years, and may not claim credits in excess of $20 million with respect to clothes washers eligible for the $50 credit and refrigerators eligible for the $75 credit. A taxpayer may elect to increase the $20 million limitation described above to $25 million provided that the aggregate amount of credits with respect to such appliances, plus refrigerators eligible for the $100 and $125 credits, is limited to $50 million for all taxable years.

Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

The credit is part of the general business credit.

Description of Proposal

The proposal extends and modifies the energy efficient appliance credit.

The proposal provides modified credits for eligible production as follows:

Dishwashers

1. $45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle, and

2. $75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes washers

1. $75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed a 8.0 water consumption factor, and

2. $125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,

3. $150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009 or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor, and

4. $250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor.

Refrigerators

1. $50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

2. $75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but no more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

3. $100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009 or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards, and

4. $200 in the case of a refrigerator manufactured in calendar year 2008, 2009 or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards.

Dehumidifiers

1. $15 in the case of a dehumidifier manufactured in calendar year 2008 that has a capacity less than or equal to 45 pints per day and is 7.5 percent more efficient than the applicable Department of Energy energy conservation standard effective October 2012, and

2. $25 in the case of a dehumidifier manufactured in calendar year 2008 that has a capacity greater than 45 pints per day and is 7.5 percent more efficient than the applicable Department of Energy energy conservation standard effective October 2012.

Appliances eligible for the credit include only those that exceed the average amount of production from the two prior calendar years for each category of appliance, rather than the present law three prior calendar years. Additionally, the special rule with respect to refrigerators is eliminated.

The aggregate credit amount allowed with respect to a taxpayer for all taxable years beginning after December 31, 2007 may not exceed $75 million, with the exception that the $200 refrigerator credit and the $250 clothes washer credit are not limited.

The term "dehumidifier" means a self-contained, electrically operated, and mechanically refrigerated encased assembly consisting of (A) a refrigerated surface that condenses moisture from the atmosphere, (B) a refrigerating system, including an electric motor, (C) an air-circulating fan, and (D) means for collecting or disposing of condensate.

The term "modified energy factor" means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.

The term "gallons per cycle" means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term "water consumption factor" means, with respect to a clothes washer, the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

Effective Date

The proposal applies to appliances produced after December 31, 2007.

5. Five-year cost recovery for qualified energy management devices

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[71] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[72] Assets included in class 49.14, describing assets used in the transmission and distribution of electricity for sale and related land improvements, are assigned a class life of 30 years and a recovery period of 20 years.

Description of Proposal

The proposal provides a five-year recovery period for any qualified energy management device. For purposes of the proposal, a qualified energy management device means any energy management device which: (1) is installed on real property of a customer of the taxpayer; and (2) is placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services that provides all commercial and residential customers with net metering upon the customer's request. For purposes of the proposal, net metering means allowing customers a credit for providing electricity to the supplier or provider.

An energy management device is any time-based meter and related communication equipment which is capable of being used by the taxpayer as part of a system that: (1) measures and records electricity usage data on a time-differentiated basis in at least 24 separate time segments per day; (2) provides for the exchange of information between the supplier or provider

[71] Sec. 168.

[72] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

and the customer's energy management device in support of time-based rates or other forms of demand response; and (3) provides data to such supplier or provider so that the supplier or provider can provide energy usage information to customers electronically.

Effective Date

The proposal is effective for property placed in service after the date of enactment.

III. REVENUE PROVISIONS

A. Denial of Oil and Gas Tax Benefits

1. Denial of deduction for income attributable to domestic production of oil, natural gas, or primary products thereof

Present Law

In general

Section 199 of the Code provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[73]

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts and (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States;[74] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the

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[73] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

[74] Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;[75] or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

Congress granted Treasury broad authority to "prescribe such regulations as are necessary to carry out the purposes" of section 199.[76] In defining MPGE for purposes of section 199, Treasury described the following as MPGE activities: manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.[77]

The regulations specifically cite an example of oil refining activities in describing the "in whole or in significant part" test in determining domestic production gross receipts. QPP is generally considered to be MPGE in significant part by the taxpayer within the United States if such activities are substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States.[78] The following example is provided in the regulations to illustrate this "substantial in nature" standard:

> X purchases from Y, an unrelated person, unrefined oil extracted outside the United States. X refines the oil in the United States. The refining of the oil by X is an MPGE activity that is substantial in nature.[79]

<u>Electricity or natural gas transmission or distribution</u>

Although domestic production gross receipts include the gross receipts from the production in the United States of electricity and gas, the provision excludes gross receipts from the transmission or distribution of electricity and gas. Thus, in the case of a taxpayer who owns a facility for the production of electricity (either as part of a regulated utility or an independent power facility), the taxpayer's gross receipts from the production of electricity at that facility are

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[75] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

[76] Sec. 199(d)(9).

[77] Treas. Reg. sec. 1.199-3(e)(1).

[78] Treas. Reg. sec. 1.199-3(g)(2).

[79] Treas. Reg. sec. 1.199-3(g)(5), Example 1.

qualified domestic production gross receipts. However, to the extent that the taxpayer is an integrated producer that generates electricity and delivers electricity to end users, any gross receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution and any gross receipts properly attributable to the distribution of electricity to final customers are not qualified domestic production gross receipts.

For example, taxpayer A owns a wind turbine that generates electricity and taxpayer B owns a high-voltage transmission line that passes near taxpayer A's wind turbine and ends near the system of local distribution lines of taxpayer C.[80] Taxpayer A sells the electricity produced at the wind turbine to taxpayer C and contracts with taxpayer B to transmit the electricity produced at the wind turbine to taxpayer C who sells the electricity to his or her customers using taxpayer C's distribution network. The gross receipts received by taxpayer A for the sale of electricity produced at the wind turbine constitute qualifying domestic production gross receipts. The gross receipts of taxpayer B from transporting taxpayer A's electricity to taxpayer C are not qualifying domestic production gross receipts. Likewise, the gross receipts of taxpayer C from distributing the electricity are not qualifying domestic production gross receipts. Also, if taxpayer A made direct sales of electricity to customers in taxpayer C's service area and taxpayer C received remuneration for the distribution of electricity, the gross receipts of taxpayer C are not qualifying domestic production gross receipts. If taxpayers A, B, and C are all related taxpayers, then taxpayers A, B, and C must allocate gross receipts to production activities, transmission activities, and distribution activities in a manner consistent with the preceding example.

The same principles apply in the case of the natural gas industry. In the case of natural gas, production activities generally are all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas. Such activities would produce qualifying domestic production gross receipts. However, gross receipts of a taxpayer attributable to transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are not qualified domestic production gross receipts. Likewise, gas purchased by a local gas distribution company and distributed from the citygate to the local customers does not give rise to domestic production gross receipts.[81]

<u>Drilling oil or gas wells</u>

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.[82] Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of

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[80] H.R. Rep. No. 108-755 (conference report for the American Jobs Creation Act of 2004), footnote 28 at 272.

[81] Id.

[82] Treas. Reg. sec. 1.199-3(m)(1)(i).

Treas. Reg. sec. 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.[83]

Qualifying in-kind partnerships

In general, an owner of a pass-thru entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for "qualifying in-kind partnerships," which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[84] In the case of a qualifying in-kind partnership, each partner is treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner.[85] If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property.[86]

Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Description of Proposal

The proposal excludes gross receipts of the taxpayer derived from the sale, exchange, or other disposition of oil, natural gas, or any primary product thereof from the term "domestic production gross receipts" for purposes of section 199. The term "primary product" has the same meaning as when used in section 927(a)(2)(C), as in effect before its repeal. The Treasury regulations define the term "primary product from oil" to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues

[83] Treas. Reg. sec. 1.199-3(m)(2)(iii).

[84] Treas. Reg. sec. 1.199-9(i)(2).

[85] Treas. Reg. sec. 1.199-9(i)(1).

[86] Id.

such as fuel oil.[87] Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.[88] The term "primary product from gas" is defined as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline.[89] These primary products and processes are not intended to represent either the only primary products from oil or gas or the only processes from which primary products may be derived under existing and future technologies.[90] Examples of nonprimary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.[91]

Effective Date

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

2. 7-year amortization of geological and geophysical expenditures for major integrated oil companies

Present Law

Geological and geophysical expenditures ("G&G costs") 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 by independent producers and smaller integrated oil[92] companies in connection with oil and gas exploration in the United States may generally be amortized over two years.[93] Major integrated oil companies are required to amortize all G&G costs over five years.[94] For purposes of this provision, a major integrated oil company, with respect to any taxable year, is a producer of crude oil which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable

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87 Treas. Reg. sec. 1.927(a)-1T(g)(2)(i).

88 Id.

89 Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii).

90 Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii).

91 Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv).

92 Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

93 Sec. 167(h)(1).

94 Sec. 167(h)(5).

year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more. [95]

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property as all basis is recovered over the applicable amortization period.

Description of Proposal

The proposal extends from five years to seven years the amortization period for G&G costs for major integrated oil companies.

Effective Date

The proposal is effective for amounts paid or incurred after the date of enactment.

3. Require taxpayers to use an arm's-length fair-market value price for purposes of calculating FOGEI and FORI; treat industry-specific taxes as attributable solely to FOGEI

Present Law

In general

Foreign tax credit

The United States taxes its citizens and residents (including U.S. corporations) on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States generally provides a credit against U.S. tax liability for foreign income taxes paid or accrued.[96] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to an indirect (also referred to as a deemed paid) credit for those taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[97]

Foreign tax credit limitations

The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income. This general limitation is intended to ensure that the credit serves its purpose of

[95] Id.

[96] Sec. 901.

[97] Secs. 902 and 960.

mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[98]

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the foreign tax credit used to offset the U.S. tax on income in each separate limitation category may not exceed the proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income in that category bears to its worldwide taxable income in that category. The separate limitation rules are intended to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income.[99]

Special limitation on credits for foreign extraction taxes and taxes on foreign oil related income

In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on foreign income taxes on foreign oil and gas extraction income ("FOGEI").[100] Under this special limitation, amounts claimed as taxes paid on FOGEI of a U.S. corporation qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed the product of the highest marginal U.S. tax rate on corporations (presently 35 percent) multiplied by such extraction income. Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible. The amount of any such taxes paid or accrued (or deemed paid) in any taxable year which exceeds the FOGEI limitation may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess FOGEI limitation for those years.[101]

A similar special limitation applies, in theory, to foreign taxes paid on foreign oil related income ("FORI") in certain cases where the foreign law imposing such amount of tax is structured, or in fact operates, so that the amount of tax imposed with respect to foreign oil related income will generally be "materially greater," over a "reasonable period of time," than

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[98] Sec. 904(a).

[99] Sec. 904(d). For taxable years beginning prior to January 1, 2007, section 904(d) provides eight separate baskets as a general matter, and effectively many more in situations in which various special rules apply. The American Jobs Creation Act of 2004 reduced the number of baskets from nine to eight for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two (i.e., "general" and "passive") for taxable years beginning after December 31, 2006. Pub. L. No. 108-357, sec. 404 (2004).

[100] Sec. 907(a).

[101] Sec. 907(f). These carryback and carryforward rules are similar to the general foreign tax credit carryback and carryforward rules of section 904(c).

the amount generally imposed on income that is neither FORI nor FOGEI.[102] Under the FORI rules, if this theoretical limitation were to apply, then the portion of the foreign taxes on FORI so disallowed would be recharacterized as a (non-creditable) deductible expense.[103]

As a general matter, the FOGEI and FORI rules of section 907 are informed by two related but distinct concerns. First, as described by the Staff of the Joint Committee on Taxation in 1982, the rules were designed to address the perceived problem of "disguised royalties" being improperly treated as creditable foreign taxes:

> When U.S. oil companies began operations in a number of major oil exporting countries, they paid only a royalty for the oil extracted since there was generally no applicable income tax in those countries. However, in part because of the benefit to the oil companies of imposing an income tax, as opposed to a royalty, those countries have adopted taxes applicable to extraction income and have labeled them income taxes. Moreover, because of this relative advantage to the oil companies of paying income taxes rather than royalties, many oil-producing nations in the post-World II era have tended to increase their revenues from oil extraction by increasing their taxes on U.S. oil companies.[104]

In addition, the section 907 rules have also been described as intended to prevent the crediting of high foreign taxes on FOGEI and FORI against the residual U.S. tax on other types of lower-taxed foreign source income.[105] Consistent with this concern, between 1975 and 1982 the foreign tax credit rules provided a separate limitation category (or "basket") under the general section 904 limitation for foreign oil income (broadly defined to include both FORI and FOGEI within the meaning of present law section 907); this separate basket for foreign oil income was eliminated when the present law FORI rules were added and other changes were made by the Tax Equity and Reform Act of 1982.[106]

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[102] Sec. 907(b).

[103] Treas. Reg. sec. 1.907(a)-0(d).

[104] Joint Committee on Taxation, *Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, (JCS-38-82), December 31, 1982, sec. IV.A.7.a, footnote 63.

[105] H.R. Conf. Rep. No. 103-213, at 646 (1993).

[106] Pub. L. No. 97-248, sec. 211(c) (1982).

Determination of FOGEI and FORI

In general

Determination of a taxpayer's FOGEI and FORI is highly specific to the taxpayer's relevant facts and circumstances. Under section 907(c)(1), FOGEI is defined as taxable income derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in the trade or business of extracting those minerals.[107] The regulations provide that "gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well."[108]

The regulations do not provide specific methods for determining the fair market value of the extracted oil or gas in the immediate vicinity of the well, but simply provide that all the facts and circumstances that exist in the particular case must be considered, including (but not limited to) facts and circumstances pertaining to the independent market value (if any) in the immediate vicinity of the well, the fair market value at the port of the foreign county, and the relationships between the taxpayer and the foreign government.[109]

Section 907(c)(2) defines FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities, and from the performance of any other related service.[110]

As a result of these separate rules governing FOGEI and FORI and the interaction between them, a taxpayer's determination of the amounts of FOGEI and FORI, as well as the allocation of foreign taxes to each class of income, can have a significant impact on the taxpayer's overall U.S. tax liability.

IRS field directive

An October 12, 2004, IRS field directive (the "2004 Field Directive") sets forth guidance to international examiners and specialists on the application of what it describes as the two most commonly used methods for determining FOGEI and FORI when there is no ascertainable market price for the oil and gas in the immediate vicinity of the well, namely the residual (rate of return) method and the proportionate profits method.

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[107] Sec. 907(c)(1).

[108] Treas. Reg. sec. 1.907(c)-1(b)(2).

[109] Treas. Reg. sec. 1.907(c)-1(b)(6).

[110] Sec. 907(c)(1); Treas. Reg. sec. 1.907(c)-1(d).

Under the residual (rate of return) method, the taxpayer first calculates FORI by applying an assumed after-tax rate of return to the cost of its fixed "FORI assets." Then, because income from the production and sale of oil and gas product is equal to the sum of FORI and FOGEI, FOGEI is determined by subtracting FORI (as calculated) from the taxpayer's total foreign income from the production and sale of oil and gas product.

Under the proportionate profits method, the taxpayer allocates total income from the production and sale of the oil or gas product between FOGEI and FORI based on the relative costs of the FOGEI and FORI activities.

Under either method, the taxpayer must determine its total income from the production and sale of oil and gas product, and must distinguish between costs and assets classified as relating to FOGEI and those relating to FORI. Under the residual (rate of return) method, the taxpayer must also determine appropriate rates of return for FORI assets. The 2004 Field Directive sets forth examples of FOGEI assets[111] and FORI assets,[112] and further provides that assets that support both FOGEI and FORI may be allocated by any reasonable method.[113]

Apportionment of foreign taxes between FOGEI and FORI

Under the Code, foreign taxes will be treated as oil and gas extraction taxes (and thus subject to the FOGEI limitation) to the extent they are paid or accrued during the taxable year with respect to FOGEI.[114] Treasury Regulations generally provide that, if a relevant foreign country imposes and collects foreign taxes on a single tax base that consists partly of amounts classified as FOGEI and partly of amounts classified as FORI, then such foreign taxes shall be allocated in proportion to such amounts of FORI and FOGEI. For instance, suppose that a foreign country ("County X") has a corporate income tax system which taxes, at an aggregate rate of 40 percent, all Country X-source oil and gas income (broadly defined, so that all of the

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[111] Memorandum for Industry Directors ("Field Directive on IRC §907 Evaluating Taxpayer Methods of Determining Foreign Oil and Gas Extraction Income (FOGEI) and Foreign Oil Related Income (FORI)"), October 12, 2004 (Tax Analysts Doc 2004-23010; 2004 TNT 233-8). By its terms, the 2004 Field Directive "is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such."

[112] Examples of FOGEI assets include wells, wellheads, and pumping equipment; slug catchers, separators, treaters, emulsion breakers and stock tanks needed to obtain marketable crude (for oil production); primary separation and dehydration equipment needed to arrive at a gaseous stream in which hydrocarbons may be recovered (for gas production); lines interconnecting the above; the infrastructure-type equipment to provide for the operation of the above; and structures to physically support the above (such as offshore platforms).

[113] Examples of FORI assets include lines that carry natural gas beyond the primary separator and dehydration equipment and towards its sales point, and compressors needed to transport through these lines; lines that carry marketable crude oil from the premises, as well as pumps needed to transport crude oil through these lines; and assets used to process crude oil and natural gas.

[114] Sec. 907(c)(5).

taxpayer's Country X-source income will be subject to this tax rate); suppose further that the taxpayer's total Country X taxable income (which is assumed here to be calculated identically for U.S. and Country X tax purposes) is $4,000, resulting in a Country X tax of $1,600. This $1,600 of tax will be apportioned between FOGEI and FORI in proportion to the relevant amounts of the taxpayer's Country X FOGEI and FORI.

Description of Proposal

Under the proposal, taxpayers are no longer permitted to calculate FOGEI and FORI using the methods described in the 2004 Field Directive; instead, taxpayers must identify the first point in time at which the oil or gas has a fair market value which can be determined on the basis of either (i) a transfer, in an arm's-length transaction, of such oil or gas to an unrelated third party by the taxpayer, or (ii) the arrival of such oil or gas at a location at which the fair market value is readily ascertainable by reason of transactions among unrelated third parties with respect to oil or gas that is substantially identical to such oil or gas (taking into account source, location, quality, and chemical composition). Thus, for example, where a taxpayer extracts crude oil at an offshore platform (and no readily ascertainable fair market value can be determined based upon comparable arm's-length sales in the immediate vicinity of the wellhead) and transports the crude oil via underwater pipelines (owned by the taxpayer) to a port facility (where other unrelated parties are engaged in arm's-length purchase and sale transactions involving substantially identical crude oil), the taxpayer is required to use the independent fair market value of the crude oil at the port facility for purposes of calculating FOGEI. In such circumstances, the taxpayer is permitted to deduct the cost of transporting the crude oil to the port facility (as measured by its operating expenses attributable to the transportation activity, including depreciation of the pipeline) from its gross income (calculated with reference to the relevant independent fair market value so determined) to determine overall FOGEI.

In addition, the proposal also requires that, where a foreign country collects taxes that are limited in their application to taxpayers engaged in oil or gas activities, such a taxpayer is required to treat the entire amount of such taxes as oil and gas extraction taxes subject to the FOGEI limitation (rather than apportioning such taxes between FOGEI and FORI). In such a case, the taxpayer treats the entire amount of income on which such taxes are imposed as FOGEI.

Effective Date

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

B. Clarification of Eligibility for Certain fuel Credits

1. Clarification of eligibility for renewable diesel credit for fuel co-produced with petroleum products

Present Law

Renewable diesel

The Code provides a tax incentive of $1.00 per gallon for renewable diesel. This incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[115] "Renewable diesel" means diesel fuel that (1) is derived from biomass (as defined in section 45K(c)(3)) using a thermal depolymerization process; (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under section 211 of the Clean Air Act (42 U.S.C. sec. 7545); and (3) meets the requirements of the American Society of Testing and Materials ("ASTM") D975 or D396. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces.

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

Liquid hydrocarbons from biomass

The Code provides an excise tax credit 50 cents per gallon for certain alternative fuels.[116] Included among the qualified alternative fuels is a provision for liquid hydrocarbons produced from biomass. Neither the Code, nor Treasury guidance define "liquid hydrocarbons." However, fuel that is ethanol, methanol, biodiesel, or renewable diesel does not qualify as an alternative fuel.

Description of Proposal

The proposal overrides IRS Notice 2007-37 with respect to co-produced fuel, providing that renewable diesel does not include any fuel derived from co-processing biomass with a feedstock that is not biomass. The deminis use of catalysts, such as hydrogen, is permitted under the proposal. The proposal also clarifies the alternative fuel credit by replacing the term "liquid hydrocarbons" with "liquid fuel." The proposal provides that alcohol, biodiesel, renewable

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[115] Secs. 40A, 6426(c), and 6427(e). For purposes of the Code, renewable diesel is generally treated as biodiesel.

[116] Sec. 6426(d). This incentive also can be taken as a payment under section 6427(e).

diesel, and qualified mixtures thereof (as subsections (b) and (c) of section 6426 and sections 40 and 40A) do not qualify for the alternative fuel and alternative fuel mixture credit.

Effective Date

The proposal is generally effective for fuel produced and sold or used after June 30, 2007. The alternative fuel clarification is effective as if included in section 11113 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users.

2. Clarification that credits for fuel are designed to provide an incentive for United States production

Present Law

The Code provides per-gallon incentives relating to the following qualified fuels: alcohol (including ethanol), biodiesel (including agri-biodiesel), renewable diesel, and certain alternative fuels.[117] The incentives may be taken as an income tax credit, excise tax credit or payment. The provisions are coordinated so that a gallon of qualified fuel is only taken into account once. If the qualified fuel is part of a qualified fuel mixture, the incentives apply only to the amount of qualified fuel in the mixture.

For alcohol, other than ethanol, the amount of the credit is 60 cents per gallon. For ethanol, the credit is 51 cents per gallon. The alcohol incentives expire after December 31, 2010. The amount of the credit for biodiesel is 50 cents. For agri-biodiesel and renewable diesel, the credit amount is $1.00 per gallon. The biodiesel, agri-biodiesel and renewable diesel incentives expire after December 31, 2008. The credit amount for alternative fuels is 50 cents per gallon. The incentives for alternative fuels expire after September 30, 2009 (after September 30, 2014, in the case of liquefied hydrogen).

The Code is silent as to the geographic limitations on where the fuel must be produced, used, or sold. For imported ethanol, there is an offsetting tariff of 54 cents per gallon. This tariff expires January 1, 2009.

Description of Proposal

The proposal makes a technical correction to clarify that foreign-produced fuel that is used or sold for use outside of the United States is ineligible for the per-gallon tax incentives relating to alcohol, biodiesel, renewable diesel, and alternative fuel.

On a prospective basis, the proposal limits the per-gallon tax incentives for biodiesel (including agri-biodiesel), renewable diesel, and alternative fuels to fuels produced in the United States that are used or sold for use in the United States. For this purpose, "United States" includes any possession of the United States. The taxpayer must obtain a certification from the producer of the fuel that identifies the product produced and the location of such production. For

[117] See secs. 40, 40A, 6426, and 6427(e).

example, whether part of a qualified mixture or alone, biodiesel only qualifies for the credit if the biodiesel is produced in the United States for consumption in the United States. Thus, foreign-produced biodiesel, although imported into the United States for consumption in the United States, does not qualify for the credit. Similarly, domestically produced biodiesel sold for export does not qualify for the credit.

Effective Date

For foreign produced alcohol and biodiesel used outside of the United States, the proposal is effective as if included in section 301 of the American Jobs Creation Act of 2004; for foreign produced renewable diesel used outside of the United States, the proposal is effective as if included in section 1346(c) of the Energy Policy Act of 2005; and for foreign produced alternative fuel used outside of the United States, the proposal is effective as if included in section 11113 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users. The proposal, as it relates to the restriction of the payments and credits to fuel both produced and used in the United States is effective for fuel produced, sold or used after the date of enactment.

IV. OTHER PROVISIONS

A. Studies

1. Carbon audit of provisions of the Internal Revenue Code of 1986

Present Law

Present law does not require a review of the Code for provisions that affect carbon emissions and climate. The National Research Council is part of the National Academies. The National Academy of Sciences serves to investigate, examine, experiment and report upon any subject of science whenever called upon to do so by any department of the government. The National Research Council was organized by the National Academy of Sciences in 1916 and is its principal operating agency for conducting science policy and technical work.

Description of Proposal

The proposal directs the Secretary to request that the National Academy of Sciences undertake a comprehensive review of the Code to identify the types of and specific tax provisions that have the largest effects on carbon and other greenhouse gas emissions and to generally estimate the magnitude of those effects.[118] The report should identify the provisions of the Code that are most likely to have significant effects on carbon emissions and discuss the importance of controlling carbon and greenhouse gas emissions as part of a comprehensive national strategy for reducing U.S. contributions to global climate change.[119] The report will describe the processes by which the tax provisions affect emissions (both directly and indirectly), assess the relative influence of the identified provisions, and evaluate the potential for changes in the Code to reduce carbon emissions. The report will also identify other provisions of the Code that may have significant influence on other factors affecting climate change.

The Secretary is to submit to Congress a report containing the results of the National Academy of Sciences review within two years of the date of enactment. The proposal authorizes the appropriation of $1,500,000 to carry out the review.

Effective Date

The proposal is effective on the date of enactment.

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[118] A detailed quantitative analysis is not required. It is envisioned that the review will catalogue and provide a general analysis of the effect of each identified provision.

[119] "Greenhouse gas emissions" include, but are not limited to, methane, nitrous oxide, ozone, and fluorinated hydrocarbons.

2. Comprehensive study of biofuels production

Present Law

The National Academy of Sciences serves to investigate, examine, experiment and report upon any subject of science whenever called upon to do so by any department of the government. The National Research Council is part of the National Academies. The National Research Council was organized by the National Academy of Sciences in 1916 and is its principal operating agency for conducting science policy and technical work.

Description of Proposal

The proposal requires the Secretary, in consultation with the Department of Energy and the Department of Agriculture, to request that the National Academy of Sciences produce an analysis of current scientific findings to determine:

1. Current biofuels production, as well as projections for future production;

2. The maximum amount of biofuels production capable on U.S. farmland;

3. The domestic effects of a dramatic increase in biofuels production on, for example, (a) the price of fuel, (b) the price of land in rural and suburban communities, (c) crop acreage and other land use, (d) the environment, due to changes in crop acreage, fertilizer use, runoff, water use, emissions from vehicles utilizing biofuels, and other factors, (e) the price of feed, (f) the selling price of grain crops, (g) exports and imports of grains, (h) taxpayers, through cost or savings to commodity crop payments, and (i) refinery expansion in the United States;

4. The ability to convert corn ethanol plants for other uses, such as cellulosic ethanol or biodiesel;

5. A comparative analysis of corn ethanol versus other biofuels and renewable energy sources, considering cost, energy output, and ease of implementation; and

6. The need for additional scientific inquiry, and specific areas of interest for future research.

The National Academy of Sciences shall issue an initial report of its findings to the Congress not later than three months after the date of enactment, and a final report not later than six months after the date of enactment.

Effective Date

The proposal is effective on the date of enactment.