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Emergency Economic Stabilization Act of 2008

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Overview

Over the weekend of September 27-28, it appeared that the U.S. House had reached agreement on a massive bill, the Emergency Economic Stabilization Act of 2008 (Act), designed to help put the U.S. financial sector back on its feet and calm Wall Street's fears. However, the House failed to pass the Act on September 29 by a 228-205 vote. The vote came after a five-minute partisan speech by House Speaker Pelosi who blamed the current problem in the financial markets on the Bush Administration. The Senate took up its own version of the Act and passed it on October 1 by a 74-25 margin. The two bills are similar in many respects, but the Senate version also contained language that extends expired or expiring tax provisions, and Midwestern disaster relief. The House then considered the Senate version of the legislation (H.R. 1424, Pub.L. No. 110-343) and passed it by a 263-171 margin.

The President immediately signed the bill.

How did Iowans vote?

Yes: Harkin, Grassley; Braley, Boswell, Loebsack
No: Latham, King

The Act (both House and Senate versions) authorizes the federal government to buy troubled assets and acquire equity in distressed financial firms, and requires the Treasury Department to make rules to prevent excessive compensation for executives whose companies benefit from the legislation. The Act also sets up an oversight board with the authority to halt the program, a special investigator general to monitor the program and regular governmental audits. The Act also requires the government to renegotiate mortgages that it acquires under the program. Money to acquire the troubled assets will be phased in – with $250 billion immediately available, an additional $100 billion to be appropriated if the Treasury Secretary certifies its need, and a final $350 billion available upon additional certification and Congressional approval.

Non-Tax Provisions

On the House side, the Act was originally drafted as a three-page bill. But, it quickly morphed into a 110-page bill. The Act contains numerous non-tax provisions. While some questionable and likely unnecessary provisions got added to the bill, other bad provisions got stripped out during negotiations. The Act grants extraordinary powers to the Treasury Secretary – basically a blank check rather than legislative direction concerning what is permissible action. In essence, the Secretary can hire, fire, contract, issue regulations, "establish vehicles" to hold assets, with the Secretary's decisions only subject to limited judicial review. The Secretary must consult with various agencies, to issue regulations and take necessary steps to prevent "unjust enrichment" – whatever that means. The Act also states that the Secretary is to "take into consideration" nine worthy factors

when implementing the program, and must promulgate conflict of interest regulations. Also, the Act provides for limits on executive compensation (no golden parachute payments to a senior executive officer during the period that the Secretary holds an equity or debt position in the financial institution), and establishes an oversight board consisting of Treasury, the Securities and Exchange Commission, the Federal Reserve, an obscure housing regulator and the Secretary of the Department of Housing and Urban Development. These persons can only be fired for cause – which limits the President's oversight ability (and is probably unconstitutional as in violation of Article II of the Constitution).

The Act specifies that the powers given the Secretary are not subject to injunctive or equitable relief, and yet the Act carefully limits injunctive relief in some situations (not sure what that is all about).

Tax Provisions

The Act contains several important tax provisions:

- Ordinary loss treatment on Fannie Mae and Freddie Mac preferred stock held by financial institutions if the stock was held on September 6, 2008, or if it was sold from January 1, 2008 through September 6, 2008.

  Note: This is designed to help smaller banks that had overinvested in Fannie Mae and Freddie Mac. Without the change in the tax rule, these banks (which are typically C corporations) would not have been able to deduct much of the losses. That's because capital losses of C corporations are deductible only to the extent of capital gains, and expire if not used in five years.

- $500,000 annual compensation deduction ceiling for the top CEO and top three employees of institutions that participate in the program, and a 20 percent excise tax on payments over a threshold amount that is due if the executive leaves for reasons other than a standard retirement for which the executive is eligible (applicable to companies that have more than $300 million of assets purchased by the Treasury).

  Note: The deduction ceiling was added by Rep. Barney Frank (D-Mass.) and Sen. Chris Dodd (D-CT.) who did not object to executive compensation packages on prior occasions. A potential problem with this provision is that troubled financial institutions are not likely to be able to attract the cream of the crop, and this provision could create a perverse incentive to not hire top talent.

- An extension of the non-taxability of cancelled debt on home mortgages (up to $2 million) through 2012.

Senate Version

The Senate version (over 400 pages long) combines the financial "bailout" provisions that failed in the House with one additional item – a temporary increase in the Federal Depository Insurance Corporation's (FDIC) insurance limit from $100,000 to $250,000 per bank account (effective from Oct. 3, 2008, through Dec. 31, 2009). The bill also includes the three tax provisions that were in the House version and includes numerous "extender" provisions (including the 0.2 percent FUTA surcharge) and disaster-related tax relief for the Midwest. Also included in the bill is approximately $17 billion in tax cuts for "renewable" energy, and a one-year patch to the alternative minimum tax.

The bill consists of three major Divisions, with each Division containing some tax provisions. Each Division has its own "short title" with section numbers beginning at 101 in each Division. Division A is the "Emergency Economic Stabilization Act of 2008," Division B is the "Energy Improvement and Extension

Act of 2008" and Division C is the Tax Extenders and Alternative Minimum Tax Relief Act of 2008."

The following is a summary of the most significant tax provisions contained in H.R. 1424, Pub.L. No. 110-343 (which became law on October 3, 2008):

Division A – The Emergency Economic Stabilization Act of 2008

- Ordinary loss treatment on Fannie Mae and Freddie Mac preferred stock held by financial institutions if the stock was held on September 6, 2008, or if it was sold from January 1, 2008 through September 6, 2008. *Act, Division A, Title III, Sec. 301. Effective for sales or exchanges occurring after December 31, 2007, in tax years ending after 2007.*

- $500,000 annual compensation deduction ceiling for the top CEO and top three employees of institutions that participate in the program, and a 20 percent excise tax on payments over a threshold amount that is due if the executive leaves for reasons other than a standard retirement for which the executive is eligible (applicable to companies that have more than $300 million of assets purchased by the Treasury). *Act, Division A, Title III, Sec. 302, amending I.R.C. §162(m).*

- An extension of the non-taxability of cancelled debt on home mortgages (up to $2 million on a joint return) through 2012. *Act, Division A, Title III. Sec. 303, amending I.R.C. §108(a)(1)(E).*

Division B – The Energy Improvement and Extension Act of 2008

- Extension of the "renewable" energy credit through 2009, for wind and refined coal, and through 2010 for other sources of "renewable" energy. *Act, Division B, Title I, Subtitle A, Sec. 101, amending I.R.C. §45(d).*

  Note: The Act also expands the types of facilities qualifying for the credit to new biomass facilities and to those that generate electricity from marine renewables (e.g., waves and tides). *Act, Division B, Title I, Subtitle A, Sec. 102, amending I.R.C. §45(d).*

- Extension of the 30 percent energy-efficient property credit through 2016, with the credit offsetting AMT liability. *Act, Division B, Title I, Subtitle A, Sec. 103, amending I.R.C. §48(a), (c)(1) and (c)(2).*

  - Qualified solar energy property (and removal of the $2,000 maximum limit), and qualified fuel cell property.

  - 10 percent credit for micro-turbines.

  - Credit for the building of small wind turbines (nameplate capacity of not more than 100 kw) used to generate electricity, capped at $4,000 per year. *Act, Division B, Title I, Subtitle A, Sec. 104, amending I.R.C. §48(c). Effective for periods after October 3, 2008, in tax years ending after Oct. 4, 2008, through 2016.*

  - Credit worth 30 percent of the cost (capped at $2,000 per year), for geothermal heat pump systems through 2016. *Act, Division B, Title I, Subtitle A, Sec. 105, amending I.R.C. §48(a) by adding new subsection vii. Effective for periods after October 3, 2008, in tax years ending after October 3, 2008.*

  - Extension of the residential energy efficient property credit to property placed in service on or before December 21, 2016. *Act, Division B, Subtitle A, Sec. 106, amending I.R.C. §250D(g).*

- The creation of a credit for carbon dioxide sequestration in the amount of $20 per metric ton of qualified carbon dioxide (captured from an industrial source) which the taxpayer captures at a qualified facility (an industrial facility at which carbon

capture equipment is placed in service which captures not less than 500,000 metric tons of carbon dioxide during the tax year) the taxpayer owns and disposes of in secure geological storage, and $10 per metric ton of qualified carbon dioxide which the taxpayer captures at a qualified facility and uses as a tertiary injectant in a qualified oil or natural gas recovery project. *Act, Division B, Title I, Subtitle B, Sec. 115, adding I.R.C. §45Q. Effective for carbon dioxide captured after October 3, 2008.*

- Expansion of the 50 percent bonus depreciation allowance for cellulosic biofuels property to cellulosic biofuels other than ethanol. *Act, Division B, Title II, Sec. 201, amending I.R.C. §168(l). Effective for property placed in service after October 3, 2008, and before 2013, and for tax years ending after October 3, 2008.*

- Extension of the credit for biodiesel and "renewable" diesel through 2009, and increasing the credit from $.50 to $1.00, for fuel produced, sold or used in 2009. *Act, Division B, Title II, Sec. 202, amending I.R.C. §40A(g); 6426(c)(6) and 6427(e)(5)(B).*

- Clarification that fuel credits are designed to provide an incentive for domestic production by specifying that imported biodiesel that is immediately resold is ineligible for the biodiesel fuel credit. *Act, Division B, Title II, Sec. 203, amending I.R.C. §40A(d). Effective for claims for credit or payment made on or after May 15, 2008.*

- A three-month extension, through 2009, and modification of the alternative fuel credit. *Act, Division B, Title II, Sec. 204, amending I.R.C. §6426(d). Effective to fuel sold or used after October 3, 2008.*

- Creation of a credit for new qualified plug-in electric drive motor vehicles in the amount of $2,500 plus $417 for each kilowatt hour of traction battery capacity in excess of 4 KwH (subject to a ceiling amount on the credit based on the GVW rating of the vehicle). *Act, Division B, Title II, Sec. 205, creating I.R.C. §30D. Effective for tax years beginning after 2008 and for eligible property purchased before 2015.*

  - The credit is subject to a ceiling amount of $7,500 for qualified vehicles with a gross vehicle weight (GVW) rating of 10,000 pounds or less (higher limits apply to heavier vehicles).

  - The credit is subject to a phaseout period beginning with the second calendar quarter following the calendar quarter which includes the first date on which the total number of a qualified vehicle sold for use in the U.S. is at least 250,000. The rate of reduction of the credit is 50 percent for the first two calendar quarters of the phaseout period, and 25 percent for the third and fourth calendar quarters of the phaseout period.

  - A vehicle that qualifies for the credit is one that draws propulsion using a traction battery using at least 4 KwH of capacity, uses an offboard source of energy to recharge the battery, has a GVW rate (for passenger vehicles) of 8,500 pounds or less, and conforms to applicable Clean Air Act standards.

  - The credit can be used to offset AMT.

  - For a qualified vehicle used by a tax-exempt entity, the seller of the vehicle is treated as the taxpayer with respect to the vehicle.

  - The taxpayer must reduce their basis in the vehicle by the amount of the credit allowed.

  - A taxpayer may elect to not have the credit apply.

  - The credit is part of the general business credit.

Note: The Chevrolet Volt (forthcoming) is projected to be eligible for the full $7,500 credit by virtue of using a 16 KwH capacity Lithium-Ion battery.

- Extension of the alternative fuel vehicle refueling property credit through 2010 (2014 for hydrogen fueled vehicles). *Act, Division B, Title II, Sec. 207. Effective for property placed in service after October 3, 2008, in taxable years ending after October 3, 2008.*

- Extension through 2009 of the suspension on the taxable income limit for purposes of percentage depletion of a marginal oil or natural gas well. *Act, Division B, Title II, Sec. 210.*

- A provision allowing employers to provide employees who commute to work by bicycle limited fringe benefits (up to $20 per month as an exclusion from income) to offset the cost of such commuting. *Act, Division B, Title II, Sec. 211, amending I.R.C. S §132(f). Effective for tax years beginning after 2008.*

  Note: The provision is not indexed for inflation.

- Extension of the credit for non-business energy-saving property (such as windows, insulation and HVAC systems) through 2009, and inclusion of energy-efficient biomass fuel stoves (with a thermal efficiency rating of 75 percent or more) and asphalt roofs with cooling granules as new classes of energy-efficient property eligible for a consumer tax credit up to $500. *Act, Division B, Title III, Sec. 302. Effective for expenditures made after December 31, 2008, and before 2010.*

  Note: The bill clarifies that water heaters must have either an energy factor of at least .80 or a thermal efficiency rating of at least 90 percent to qualify for the credit. Also, while the credit is generally worth up to $500 for various improvements, it is limited to $200 for windows and $300 for biomass fuel stoves.

- Extension of the energy-efficient commercial buildings deduction through 2013. *Act, Division B, Title III, Sec. 303.*

- For eligible contractors, extension of the credit for energy-efficient improvements to new homes acquired from eligible contractors for use as a residence before 2010. *Act, Division B, Title III, Sec. 304.*

- Modification and extension of the energy-efficient appliance credit through 2010. *Act, Division B, Title III. Sec. 305.*

- A limitation on the deduction for income attributable to domestic production of oil and gas (capping the deduction at 6 percent), while extending the deduction to strategic film and television production. Effective for tax years beginning after 2008 (with the reduction taking effect in 2010). *Act, Division B, Title IV, Sec. 401, amending I.R.C. §199(d).*

- A provision requiring broker reporting of customer basis and gain in securities transactions—stocks, bonds, mutual funds and other securities using either the FIFO method or the average cost method (beginning in 2011 on a phased-in basis) on Form 1099-B. In addition, a broker must specify whether the gains are long-term or short-term. The applicable dates are as follows: 1) corporate stock-Jan. 1, 2011; (2) mutual funds-Jan. 1, 2012; (3) other securities-Jan.1, 2013.

  Note: The provision also extends the timeframe in which Form 1099-B (or statements) must be sent to customers by brokers from Jan. 31 to Feb. 15 for statements furnished after Dec. 31, 2008. In addition, for people who transfer their securities from one brokerage to another, the old broker will need to provide the new broker with the required cost basis and acquisition date

information. *Act, Division B, Title IV, Sec. 403, amending I.R.C. §6045.*

- A provision extending the .2 percent FUTA surcharge on the first $7,000 of wages (or salary) paid after December 31, 2008, through calendar year 2009 (*e.g.*, 6.2 percent; 6.0 percent beginning Jan. 1, 2010 and thereafter). *Act, Division B, Title IV, Sec. 404, amending I.R.C. §3301.*

Division C - Tax Extenders and Alternative Minimum Tax Relief Act of 2008

- An extension for 2008 of the provision allowing individuals to offset their entire regular tax liability and alternative minimum tax (AMT) liability by the non-refundable personal credits (such as the dependent care credit, education credits (Hope, Lifetime Learning Credit), adoption credit, child tax credit, retirement savers credit, credit for energy-efficient improvements to a principal residence, credit for certain solar and fuel cell equipment added to a principal residence, mortgage tax credit and the first-time D.C. homebuyer tax credit). *Act, Division C, §101, amending I.R.C. §26. Effective for tax years beginning in 2008.*

- Pegs the 2008 Alternative Minimum Tax (AMT) exemption at $69,950 for joint filers and $46,200 for single filers, and $34,975 for married persons filing separately. *Act, Division C, Title I, Sec. 102, amending I.R.C. §55(d).*

  Note: In 2009, without further legislation the AMT exemption amount will be $45,000 for married persons filing jointly (or for a surviving spouse), $33,750 for a single person (or head of household) and $22,500 for a married person filing separately.

- Cash refunds for taxpayers that exercised an incentive stock option (ISO) and got hit with alternative minimum tax of up to 50 percent of any unused long-term AMT credits (beginning in 2008), coupled with the abatement of interest and penalties attributable to unpaid taxes on ISOs, with a credit for taxpayers that have already paid such interest and penalties. *Act, Division C, Title I, Sec. 103(b), amending I.R.C. §53 by adding new subsection (f). Effective for tax years beginning after December 31, 2007.*

  Explanation: For regular tax purposes, the exercise of an ISO is not taxable. The tax event occurs when the resulting stock is sold. But, for AMT purposes, the exercise is a taxable event as ordinary income. If a taxpayer has an underpayment of tax outstanding on October 3, 2008 due to the AMT on an ISO, this tax is abated (along with interest and penalties on the underpayment). Taxpayers that paid their tax liability, but had interest and penalties because they were not able to raise the funds on time, received an increase in their Minimum Tax Credit by the "already-paid interest and penalties." Thus, those who paid on time, in accordance with the law then in effect, are not provided relief.

- Restoration for 2008 and extension through 2009 of the optional itemized deduction for state and local sales taxes in lieu of state and local income taxes. *Act, Division C, Title II, Sec. 201, amending I.R.C. §164(b)(5)(I).*

- Restoration for 2008 and extension through 2009 of the above-the-line deduction for qualified tuition and related expenses (up to $4,000). *Act, Division C, Title II, Sec. 202, amending I.R.C. §222(e).*

- Restoration for 2008 and extension through 2009 of the above-the-line deduction (up to $250) for certain expenditures incurred by elementary and secondary school teachers. *Act, Division C, Title II, Sec. 203, amending I.R.C. §62(a)(2)(D).*

- Extension through 2009 of the additional standard deduction for real property taxes for taxpayers that do not itemize (*e.g.*, up to $500 for single filers, $1,000 for MFJ) – in addition to the taxpayer's standard

deduction. *Act, Division C, Title II, Sec. 204, amending 63(c)(1)(C).*

- Restoration for 2008 and extension through 2009 of the rule allowing tax-free distributions from IRAs for charitable purposes. *Act, Division C, Title II, Sec. 205, amending I.R.C. §403(d)(8)(F).*

  Note: The privilege is only allowed to IRA owners who have reached age 70½ by the end of the applicable year (2008 or 2009). Such distributions are not subject to federal income tax.

- Restoration for 2008 and extension for 2009 of the research credit. *Act, Division C, Title III, Sec. 301, amending I.R.C. §41(h)(1)(B).*

- Restoration for 2008 and extension through 2009 of the rule providing for a basis adjustment for S corporations making charitable contributions. *Act, Division C, Title III, Sec. 307, amending I.R.C. §1367(a)(2). Effective for contributions made in tax years in 2008.*

- A two-year extension, through 2009, of the economic development credit for America Samoa. *Act, Division C, Title III, Sec. 309, amending §119(d), Division A of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, amending I.R.C. §30A.*

  Note: The provision is an ear-mark by House speaker Pelosi (D-CA) whose home district is also the headquarters of Star-Kist Tuna which has been a major contributor to Pelosi. Star-Kist is a major employer in American Samoa, and the federal minimum wage law does not apply to American Samoa (by specific exemption contained in the 2007 legislation increasing the minimum wage-it does otherwise apply to the Northern Mariana Islands). On average, the tuna industry pays laborers $3.60/hour.

- Restoration for tax years beginning in 2008, and extension for tax years beginning in 2009, of the business tax credit for employers of qualified employees that live and work on or near Indian reservations. *Act, Division C, Title III, Sec. 314, amending I.R.C. §45A(f). Effective for tax years beginning after December 31, 2007.*

- Extension of the placed-in-service date for the special depreciation recovery period for qualified Indian reservation property through 2009 for property placed in service after 2007. *Act, Division C, Title III, Sec. 315, amending I.R.C. §168(j)(8). Effective for property placed in service after December 31, 2007.*

- Restoration for 2008 and extension through 2009 of the provision allowing for the expensing of costs associated with cleaning up environmentally contaminated sites. *Act, Division C, Title III, Sec. 318, amending I.R.C. §198(h). Effective for expenditures paid or incurred after December 31, 2007.*

- Restoration for 2008 and extension through 2009 of the "enhanced charitable deduction of food inventory" provision, with elimination of the percentage limitation for contributions made by certain farmers and ranchers after December 31, 2007, but before January 1, 2009. *Act, Division C, Title III, Sec. 323, amending I.R.C. §170(e)(3)(C)(iv). Effective for contributions made after 2007.*

  Note: Because the deduction is limited to twice the taxpayer's basis in the food inventory, it provides no benefit for the vast majority of farmers (who utilize cash basis).

- A reduction in the refundable threshold for the child tax credit to $8,500 (down from $12,050) for 2008. *Act, Division C, Title V, Subtitle A, Sec. 501, amending I.R.C. §24(d). Effective for tax years beginning in 2008.*

- For property placed in service in 2009, classification of farm machinery and equipment (other than grain bins, cotton

ginning assets, fences or land improvements) for depreciation purposes as 5-year property (rather than 7-year property). *Act, Division C, Title V, Subtitle A, Sec. 505, amending I.R.C. §168(e)(3)(B). Effective for property placed in service after December 31, 2008, and before 2010.*

Note: While farm structures such as machine sheds, hog confinements and similar structures will not qualify, the equipment in those facilities can qualify. In addition, qualified equipment must be new. The new equipment will be depreciated as five-year property, while used equipment is depreciated as seven-year property. The ADS life remains at 10 years. Thus, if the election is made to use ADS depreciation, the 10-year schedule is to be used.

- The preparer standard for most undisclosed positions is reduced to substantial authority, which conforms to the taxpayer standard under I.R.C. §6662. The preparer standard for disclosed positions is set at reasonable basis. However, the preparer standard for listed transactions and reportable transactions with significant avoidance or evasion purposes is not amended – the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits. The preparer standards for disclosed and undisclosed positions are retroactively effective for returns prepared after May 25, 2007. The standard for listed and reportable transactions is effective for returns prepared after October 3, 2008. *Act, Division C, Title V, Subtitle A, Sec. 506, amending I.R.C. §6694. Effective retroactively to May 25, 2007.*

- Numerous tax relief provisions for taxpayers in any location that the President declares to be a disaster area in 2008 or 2009. *Act, Division C, Title VII, Subtitle B.*

  Note: For purposes of this Subtitle, a federally declared disaster is any disaster that is determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. *Pub. L. No. 100-707.* The provisions of this Subtitle are effective for amounts paid or incurred after 2007 in connection with federally declared disasters declared after 2007 and before 2010.

  - Disaster loss deduction. *Act, Division C, Title VII, Secs. 706 and 712, amending I.R.C. §§56, 63 and 165. Effective for losses incurred in 2008 and 2009.*

    - Net disaster losses are treated as a separate deduction from non-disaster casualty and theft losses, and the 10 percent of AGI limitation is waived for a net disaster loss. In other words, all taxpayers covered by the provision (rather than just those that itemize) can claim the casualty loss deduction regardless of the taxpayer's adjusted gross income. A net disaster loss is the excess of personal casualty losses attributable to a presidentially declared disaster occurring after December 31, 2007 and before January 1, 2010, over personal casualty gains.

    - In addition, an individual's standard deduction is increased by the disaster loss deduction (i.e., the net disaster loss). The disaster loss component of the standard deduction is allowed in computing AMTI.

    - These changes apply to the taxpayer's last tax year beginning before 2008 solely for determining the amount allowable as a net disaster loss deduction for that year if the prior year loss deduction is elected.

Note: These provisions do not apply to casualty losses sustained by taxpayers in the Midwestern disaster areas declared during the timeframe May 20, 2008 through July 31, 2008. *Act, Division C, Title VII, Subtitle B, §712.*

- Business cleanup expenses. *Act, Division C, Title VII, Secs. 707 and 712, amending I.R.C. §198A. Effective for amounts paid after 2007.*

  - A taxpayer may elect to deduct any qualified disaster expense for the tax year that it is paid or incurred.

    Note: A "qualified disaster expense" is any expenditure that the taxpayer pays or incurs in connection with a trade or business or with business-related property that otherwise would have to be capitalized, and that is: (1) for the abatement or control of hazardous substances that were released on account of a federally declared disaster; (2) debris removal or demolition of structures on real property damaged or destroyed by a federally declared disaster; or (3) for the repair of business-related property that is damaged by a federally declared disaster.

    Note: This provision does not apply to taxpayers in the Midwestern disaster areas declared during the timeframe May 20, 2008 through July 31, 2008. *Act, Division C, Title VII, Subtitle B, §712.*

  - A federally declared disaster is any disaster occurring after 2007 and before 2012 that is determined by the President to warrant assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, Pub. L. No. 100-707.

- **Net operating losses.** The Act allows taxpayers covered by the provision to carry back a qualified disaster loss five years. *Act, Division C, Title VII, Subtitle B, §708.* A "qualified disaster loss" is defined as the lesser of the taxpayer's net operating loss for the tax year or the sum of: (1) the taxpayer's losses attributable to a federally declared disaster occurring before Jan. 1, 2010, and occurring in a disaster area; and (2) the taxpayer's deduction for the tax year for qualified disaster expenses allowable under I.R.C. §198A(a) (or the amount that would have been allowable if the taxpayer deducted qualified disaster expenses).

  - A qualified disaster loss is treated as a net operating loss that is separate from the taxpayer's regular NOL.

  - In general, a taxpayer may use an AMT NOL deduction to offset only 90 percent of the taxpayer's AMTI. However, under this provision of the Act, the 90 percent limit does not apply to the portion of the AMT NOL deduction that is attributable to a qualified disaster loss.

  - This provision does not apply to taxpayers in the Midwestern disaster areas as declared from May 20, 2008 through July 31, 2008. *Act, Division C, Title VII, Subtitle B, §712.*

- **Waiver of Certain Mortgage Revenue Bond Requirements.** The Act, for taxpayers covered by the provision, waives certain revenue mortgage bond requirements that would otherwise apply in situations where the taxpayer's principal residence is destroyed or

damaged as a result of a federally declared disaster. *Act, Division C, Title VII, Subtitle B, §709, adding I.R.C. §143(k)(12) to pre-existing I.R.C. §143(k)(12)* [note: there are now two different I.R.C. §143(k)(12) subsections in the Code].

- At the taxpayer's election, if the taxpayer's principal residence is destroyed, rendered unsafe for use or relocated as a result of a federally declared disaster in 2008 or 2009, then for two years following the date of the disaster, the three year requirement of I.R.C. §143(d)(1) does not apply and the purchase price requirement is relaxed. Thus, the taxpayer may receive a mortgage loan financed with the proceeds of tax-exempt qualified mortgage bonds. The election, once made, cannot be revoked without the consent of the Commissioner. I.R.C. §143(k)(12)(A).

- At the taxpayer's election, if the taxpayer's principal residence is damaged as a result of a federally declared disaster in 2008 or 2009, any loan the taxpayer takes out to repair or reconstruct the residence in an amount that is equal to the lesser of the cost of the repair or reconstruction or $150,000 may be treated as a qualified rehabilitation loan. Thus, the loan may be financed with the proceeds of tax-exempt qualified mortgage bonds. The election is irrevocable unless the Commissioner consents. I.R.C. §143(k)(12)(B).

- Either of the above elections, once made, prevent the taxpayer from also electing to utilize the rules contained in I.R.C. §143(k)(11).

- This provision does not apply to taxpayers in the Midwestern disaster areas as declared from May 20, 2008 through July 31, 2008. *Act, Division C, Title VII, Subtitle B, §712.*

- Special Depreciation Allowance for rehabilitation property. *Act, Division C, Title VII, Subtitle B, Sec. 710, amending I.R.C. §168. Effective for disasters in 2008 and 2009.*

  - New I.R.C. §168(n) allows businesses that suffered damages due to a qualifying disaster to claim an additional 50 percent first-year bonus depreciation amount for new qualifying real and personal property placed in service in a presidentially-declared disaster area. The provision is allowed for both regular tax and AMT purposes.

  - To qualify, 80 percent or more of the use of the property must be in the disaster area and be utilized in the active conduct of the taxpayer's trade or business, and the taxpayer must rehabilitate property that was damaged or replace property that was destroyed or condemned as a result of the disaster. The property must be similar in nature to the damaged or destroyed property, and be located in the same county as the property that was damaged or destroyed. In addition, the property must be placed in service before December 31 of the third year after the date on which the federally declared disaster occurs. Likewise, the provision applies to most non-residential real property and residential rental property acquired on or after the date on which the federally declared disaster occurs, that is placed in service on or before

December 31 of the fourth year following the date on which the federally declared disaster occurs.

- Increased expensing (for future disasters). *Act, Division C, Title VII, Subtitle B, Sec. 711, amending I.R.C. §179. Effective for disasters declared after 2008.*

  - New I.R.C. §179(e) increases by $100,000 the I.R.C. §179 amount available for qualifying expenditures made in the disaster area through Dec. 31, 2009. Further, the phase out is increased by $600,000 during the same timeframe.

  - Qualified I.R.C. §179 property for this purpose is defined as qualified disaster assistance property that meets the qualification requirements for the bonus depreciation rules under the Act contained in Division C, Title VII, Subtitle B, §711.

  - The provision leaves unchanged the amount that a taxpayer can elect to expense for certain sport utility vehicles and other vehicles placed in service during a tax year (expense election capped at $25,000).

- Numerous temporary tax relief provisions for all counties declared eligible for disaster assistance in AR, IL, IN, IA, KS, MI, MN, MO, NE and WI, as declared by FEMA on or after May 20, 2008 and before August 1, 2008. *Act, Division C, Title VII, Subtitle A.*

  [General summary of provisions]

  - Temporary relief provisions incorporate a number of the Hurricane Katrina and GO Zone tax relief measures. Most benefits are limited to areas within the states that were determined to warrant either individual or individual and public assistance from the federal government because of the storm, tornado or flood damage.

  - I.R.C. §7508A authorizes IRS to provide administrative relief and suspend the performance of acts such as filing income, estate or gift tax returns, paying taxes or filing claims for credits or refunds, for a period of up to one year in the case of a presidentially declared disaster or terrorist or military action. This relief was granted to taxpayers affected by Katrina for a period ending not earlier than February 28, 2006.

  - The relief is extended to taxpayers affected by presidentially declared disasters in the Midwestern disaster area defined in I.R.C. §1400S(c).

  - For 2008 and 2009, an expansion of the Hope and Lifetime Learning Credits to individuals who attend an eligible educational institution located in a Midwestern disaster area in any tax year beginning in 2008 and 2009. The doubled Hope Credit is 100 percent of the first $2,400 of qualified tuition and related expenses and 50 percent of the next $2,400 of qualified expenses, for a maximum Hope credit of $3,600. The Lifetime Learning credit is 40 percent of up to $10,000 of qualified expenses for a maximum of $4,000. *Act, Division C, Subtitle A, Sec. 702(d)(8), amending I.R.C. §1400(O).*

    Note: "Qualified expenses" include tuition, fees, books, supplies, equipment, fees for special services and room and board.

  - I.R.C. §1400S(a) allows an individual to deduct qualified disaster relief contributions up to the full amount of the contribution base and a corporation to deduct qualified contributions up to its entire taxable income. Congress extended this provision to qualified Midwestern disaster area contributions for contributions paid in cash during the period beginning on the earliest

applicable disaster date for all states and ending on Dec. 31, 2008, to a tax-exempt charity for relief efforts in one or more Midwestern disaster areas.

- An expansion of the charitable standard mileage rate for persons providing relief for the Midwestern disaster area during a period beginning on the applicable disaster date and ending on Dec. 31, 2008. Unreimbursed expenses incurred in performing services for a charitable organization are generally deductible. A taxpayer who uses his or her car to provide charitable services may deduct actual expenses or the increased charitable standard mileage rate as set by I.R.C. §302 of the Katrina Tax Relief Act of 2005 (36 cents per mile for Jan. 1 to June 30, 2008 and 41 cents per mile for Jul. 1, 2008 to Dec. 31, 2008).

- An additional exemption (applicable in 2008, 2009 tax years) for taxpayers housing a Midwestern displaced individual from a Midwestern disaster area. If the taxpayer provided a displaced person with housing free of charge for a period of 60 consecutive days ending in that tax year, then the taxpayer is entitled to an additional exemption of $500 for each displaced individual housed. Taxpayers are allowed to claim the exemption for up to four individuals and the displaced individual may not be a spouse or dependent.

- I.R.C. §1400P(a) has been expanded and provides a temporary exclusion for the value of lodging furnished in-kind to a qualified employee and the employee's family by an employer in the Midwestern disaster area. The exclusion is limited to $600 a month and is effective for lodging furnished beginning on the first day of the first month beginning after Oct. 3, 2008 and 6 months later.

- The Act provides a housing credit as part of the general business credit for qualified employers (I.R.C. §1400P(b) who provided post-disaster housing in the Midwestern disaster area to qualified employees. The credit available to the employer is equal to 30% of any amount that is excludable from the gross income of a qualified employee.

- An expansion of I.R.C. §1400S(b), providing that an individual's casualty losses attributable to the Midwestern disaster were not subject to the $100-per-casualty floor and 10%-of-AGI threshold limits on casualty loss deductions.

- An additional exception under I.R.C. §108, excluding from gross income cancellation of non-business debt by individuals in the Midwestern disaster area. It applies to all individuals with a principal residence in an area determined by the president to warrant individual or public assistance from the federal government under the Stafford Act, and to individuals who live outside the designated assistance area but actually incurred an economic loss because of the disaster.

- The Act extends the involuntary replacement period for taxpayers who receive insurance proceeds or other compensation for property that was compulsorily or involuntarily converted as a result of the Midwestern disaster. The replacement period is extended from four years to five years if substantially all of the use of the replacement property is in the Midwest disaster area.

- The look-back election is extended for calculating EIC and the refundable child credit is extended to qualified individuals in the Midwestern disaster area for tax years that include the date of the disaster.

- For tax years beginning in 2008 and 2009, the IRS is authorized to adjust the application of federal tax laws to ensure that taxpayers do not lose any deduction or credit, or experience a change of filing status, because of temporary relocations due to severe storms, tornados, or flooding in the Midwestern disaster area.

- I.R.C. §1400Q provides that any distribution from an eligible retirement plan made during a specific period to an individual living in the Midwestern disaster area on the disaster date is includible in income ratably over three years, instead of being entirely taxed in the year of distribution. In addition, the 10 percent early withdrawal penalty is waived. Further, the taxpayers must have sustained an economic loss attributable to the 2008 Midwestern storms, tornadoes or flooding and distributions are limited to $100,000. *Effective for distributions from the disaster date though 2009.*

- The Act extends loan treatment to qualified storm damage individuals who incurred losses from the 2008 Midwestern disaster and withdrew money from qualified employer plans. Normally, direct or indirect loans from qualified employer plans to a participant or beneficiary are treated as distributions. However, I.R.C. §1400Q allows a doubling of the maximum amount that can be withdrawn as a loan and provides a 1-year postponement of payments for existing plan loans for individuals living in the Midwestern disaster area on the disaster date and sustained a loss as a result. Distributions are limited to $100,000.

- The Act permits certain individuals who received retirement plan distributions earmarked for home purchases that were canceled due to the Midwestern disaster, to be recontributed to the plan tax-free and without penalty. The distribution must have been received as a 401(k) or 403(b) plan hardship distribution or as a first-time homebuyer distribution from an IRA no earlier than six months before the applicable disaster date and no later than the disaster date.

- I.R.C. §1400Q(d) permits retroactive changes to a retirement plan in response to changes in the law related to the Midwestern disaster.

- Taxpayers can elect to deduct 50% of qualified clean-up costs and capitalize the remaining 50% of the costs, for removal of debris or demolition of any structure that is necessary because of damage attributable to the Midwestern disaster. Qualified clean-up costs must be paid or incurred during a period that begins on the disaster date and ends Dec. 31, 2010.

  Note: The provision applies for both regular tax and AMT.

- The Act provides for an extension of I.R.C. §198 expensing of qualified environmental remediation expenditures paid or incurred in the Midwestern disaster area on or after the applicable disaster date and before Jan. 1, 2011. A site is treated as a qualified contaminated site only if the release or disposal of a hazardous substance at the site was caused by the Midwestern disaster.

- The Act allows a 5-year, rather than 2-year, carryback period for a Net-Operating Loss (NOL) that is a qualified Midwestern disaster loss. Expenses qualify if they are paid or incurred no earlier than the disaster date and before Jan. 1, 2011. Qualified expenses are moving expense, temporary housing expenses, and repair expenses. If elected, the 5-year carryback applies for both regular tax and AMTI. A taxpayer may elect out of the 5-year carryback period so that the NOL is subject to the

otherwise applicable carryback period (2 years).

- For Midwestern disaster area losses subject to the 5-year carryback period, I.R.C. § 1400N(k)(1)(B) removes the 90% limitation on an alternative tax net operating loss deduction (ATNOLD). Normally, a taxpayer who is calculating AMTI must compute an ATNOLD instead of deducting the regular tax NOL from AMTI and the ATNOLD cannot exceed 90% of AMTI.

- Employers in the Midwestern disaster area who employed an average of no more than 200 employees on business days during the tax year before the disaster date, are eligible for an employee retention credit. The credit is equal to 40% of qualified wages for each eligible employee. The business must be inoperable on any date after the disaster date and before Jan. 1, 2009 and wages must be paid or incurred after the applicable disaster date and before Jan. 1, 2009.

- The Act increases the rehabilitation credit to 13% for qualified rehabilitated buildings and 26% for certified historic structures located in the Midwestern disaster area for qualified rehabilitation expenditures paid or incurred between the period of the disaster date and Dec. 31, 2011.

- The Act provides additional low-income housing credit amounts for qualified buildings for states within the Midwestern disaster area for the 2008-2010 calendar hears. The credit amount yearly is $8 multiplied by the portion of the state's population in the Midwestern disaster area.

- The IRC §1400N(n) rules are extended and provide that a project operator could rely on representations about qualifying income made by an individual displaced by the Midwestern disaster in determining whether the project meets requirements for the issuance of tax-exempt bonds. The tax-exempt bonds are issued to finance qualified residential rental projects with income restrictions.

- I.R.C. §1400N(a) which authorizes the issuance of tax-exempt bonds to finance construction and rehabilitation of residential and nonresidential property in the Gulf Opportunity Zone has been extended to the Midwestern disaster area. Qualified bonds are treated as exempt-facility bonds or qualified mortgage bonds, rather than as taxable private activity bonds used for private business use. The rules apply to bonds issued in the disaster area after Oct. 3, 2008, and before Jan. 1, 2013.

- An increase in the $100 per casualty limitation to $500 for tax years beginning in 2009, with a reversion to $100 after 2009. *Act, Division C, Title VII, Subtitle B, Secs. 706 and 712, amending I.R.C. §165. Effective for tax years beginning in 2009.*

What Should the Congress Have Done?

Many years of bad lending practices (encouraged by federal legislation that inserted social policy into lending practices) have largely contributed to the present problem, and adding $700 billion in new debt (or having the Fed take the inflationary route of printing new money) doesn't address that problem. As presently structured, the Act doesn't address the possibility of a new batch of bad loans being made, doesn't regulate credit, and doesn't rein in the Community Reinvestment Act (a Jimmy Carter era law requiring banks to make loans to its entire "community"—even poor borrowers with limited ability to repay; Bill Clinton ordered new regulations to the Act in 1995 that increased access to loans by even more borrowers with the inability to repay. The Act encouraged mortgage lending through Fannie Mae and Freddie Mac). The Act also doesn't stop companies from selling as an unregulated security something which is really regulated

insurance. In 2005, the Administration pushed for reforms of Fannie Mae and Freddie Mac, with Senator McCain (R-Ariz.) sponsoring the legislation. But, the Administration's efforts were rebuffed by Senator Dodd (D-CT) and Representative Frank (D-MA) who were major recipients of campaign contributions from Fannie Mae and Freddie Mac (interestingly, Senator and presidential candidate Obama (D-IL) is the second highest recipient of such campaign contributions).

> **Note:** Also contributing to the problem was that the Clinton Administration, in 1993, capped business deductions for executive pay at $1 million (via enactment of I.R.C. Sec. 162(m)). An exception to the cap was included for performance-based pay. That exception had the effect of incentivizing the creation of compensation packages that rewarded risk, and made stock options a popular element of compensation packages - option income was not covered. Thus, executives benefitted when the stock value went up, but suffered no loss when stock values declined. After Clinton signed the bill into law, CEO compensation exploded during the balance of the 1990s - eventually reaching approximately 300 times the average worker's salary in 2000 (up from 100 times the average in 1993).

The bill represents the creation of the largest governmental department in the history of the nation, all created in a short period of time and based on fear. The Administration and the Congress chose to ignore some basic, commonsense steps that could have been taken to calm the markets – namely, elimination of the mark-to-market accounting rules (the Act does, however, give the Securities and Exchange Commission the power to suspend the mark-to-market accounting rules and directs the SEC and Treasury Secretary to conduct a study on the mark-to-market accounting standards) and the capital gains tax. Those two steps would cause money to literally flood into the market immediately. Also, there appears to be no need for the government to purchase all of the troubled bonds. Only about 7 percent of them are in foreclosure which means that 93 percent of them are still paying. So, there is no need to buy them all. Insuring the troubled ones would be a more prudent approach.

A Better Approach?

Here's what I believe the Congress should have done to deal with the core problem and let the market work things out:

1. Repeal the Community Reinvestment Act, such that loans are made based solely on a borrower's ability to repay.

2. To create a worldwide market and immediate liquidity, insure troubled bonds and mortgages with FHA-type insurance, with the following backstops:

    - Require that any delinquent mortgage to be rewritten as a fixed-rate mortgage with a market rate of interest. In the rewrite, all payments should be rolled into the balance due on the loan and all prepayment penalties should be cancelled.

    - Also, consistent with current FHA practice, if there is a foreclosure or short-sale (home is sold for less than the existing mortgage balance), the borrower should not be liable for any remaining balance. That will minimize the impact on the borrower's credit history, and the cancelled debt income would be treated under the existing rules for discharge of indebtedness income (numerous exceptions from income recognition exist).

3. Eliminate the mark-to-market accounting rules, at least on a temporary basis, as applied to troubled bonds or mortgages. That will prevent the companies from having to artificially mark down the bonds and mortgages below the value of the underlying

mortgages and real estate. That will calm the markets and troubled banks.

4. Eliminate the capital gains tax in its entirety. That will cause a flood of investment capital into the real estate and stock market and provide immediate liquidity.

5. Reform banking laws.

   - Modify the fractional reserve banking rules to eliminate all inflationary effect.

     Explanation: Banks are required to keep in reserve only a small fraction of the money deposited in them – some as low as 5 percent. The rest of the money can be loaned out. Thus, there is a multiplying effect on money. For example, assume Derrick Depositor deposits $1,000 in his checking account at Usurious State Bank and that the bank has a 5 percent reserve requirement. Derrick can now write checks against that $1,000. The bank can also lend $950 to Becky Borrower who can deposit that money in her account at her bank and write checks against it. Becky's bank can loan $902.50 to another borrower who can deposit that money in that borrower's bank, etc., etc. This process can go on until the entire $1,000 of initial deposit is used up in reserves rather than in loans. After 25 steps, the loans against the initial deposit will be $14,451.15. So, once there was only $1,000 to be spent on goods in the marketplace, but now there is suddenly there is $1,000 plus $14,451,15 competing for those same goods. That means that the price of the goods must go up because the supply of the goods has not risen along with the supply of the dollars bidding for them. Thus, fractional reserve banking, in its present state, is inflationary – it drives up prices (and consequently, drives up the demand for more credit, thus further feeding the inflationary effect). But, fractional reserves are a necessary effect of lending. So, how can the inflationary effect be controlled? The key is to prohibit the use of demand deposits as lending capital.

   - Prohibit the lending of money received as demand deposits. Consequently, demand deposits would not bear interest and would simply amount to safe storage (for which banks would charge a slight fee).

   - Prohibit interest-bearing accounts from being demand deposits and limit withdrawals to a pre-arranged term.

   - Tie the term of loans from banks to the term of the deposits that fund loans. The effect would be that money deposited to be loaned out again could not circulate in two places at once. The depositor could not use deposited funds to purchase assets at the same time a borrower used the borrowed funds to purchase assets.

   - Eliminate FDIC "insurance" – banks' guarantees to repay deposits should be based on their own assets and trustworthiness, or on their own participation in a real insurance program in which they pay premiums to a company that insures their deposits. FDIC doesn't really insure anything. The money that is used to pay off member-bank's losses does not come from premiums that banks pay. It comes from the printing of new money by the Federal Reserve. That is, by definition, inflationary. So, an FDIC deposit guarantee, when

implemented, amounts to theft from everyone in the economy (except, of course, those depositors that get reimbursed) by devaluing existing money that is circulating in the economy.

6. On a phased-in basis, reform tax laws to remove incentives for taxpayers to overinvest and/or over-leverage in the housing market.
7. Pass legislation placing reasonable controls on speculation in the financial markets. President Clinton signed legislation in 1999 (the Gramm-Leach-Bliley Act) which deregulated the banking and finance industries thereby making mergers much easier in these industries. While that is not necessarily bad in and of itself, the Act also repealed the Glass-Steagall Act of 1933 which controlled speculation. The adverse impact of that part of the Act was unforeseen.

8. Pass legislation that actually deals with the built-in incentives for CEOs of financial institutions to cheat. CEOs and top managers receive stock as compensation. Thus, they have incentive to overstate profits, which raise the value of stock when they sell stocks. They also have the incentive to invest in assets that will increase short-run profits, but not necessarily in the long-run. Clearly, the stock-option portion of CEO compensation should be dealt with. Perhaps some portion of compensation should be paid later and be tied to company performance for a few years.

In reality, the above-mentioned steps have little chance of ever being considered, much less being enacted. Too much politics is involved in the current situation and not enough economic (and common) sense.

Conclusion

In a larger sense, the current problem has been brewing for a long time and was not unexpected. The current Administration tried to warn of forthcoming problems with Fannie Mae and Freddie Mac, but clearly should have pushed harder for reforms. In addition, there are many noted economists that have been saying for years that the "New Deal" programs of the 1930s dealt the American economy a death blow that would one day fully surface. Whether that is now taking place is hard to say, but tremors in the economy have been evident for several decades – an increase in public and private debt, the savings and loan collapse, insolvent banks, insolvent insurance companies, and the inability to privatize the retirement side of Social Security. The Act doesn't address those problems.