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Selected Provisions of the Gulf Opportunity Zone Act of 2005

-by Roger A. McEwen-

Overview

On December 21, 2005, the President signed into law the Gulf Opportunity Zone Act of 2005 (H.R. 4440). The Act represents the second large tax relief bill of 2005 designed to assist individuals and businesses recover from the effects of the 2005 Gulf Coast Hurricanes. The Act also contains numerous non-hurricane related provisions and technical corrections to various tax bills dating back to 1987, but focuses primarily on the 2004 Jobs Bill (AJCA).

Hurricane Relief

The Act creates a Gulf Opportunity (GO) Zone, and specifies that businesses and individuals within the Zone are eligible for the following tax provisions contained in the Act:

Bonus depreciation. The Act increases the I.R.C. § 167 amount for the first year qualified GO Zone property is placed in service. The property may be used or new, but the original use of the property must start with the taxpayer after August 28, 2005. Residential rental property and non-residential real property must be placed in service on or before December 31, 2008. All other property must be placed in service on or before December 31, 2007. Taxpayers can elect out of bonus depreciation, and the Treasury may extend, on a taxpayer-by-taxpayer basis, the required date of placement in service of qualifying property.

Expense method depreciation. The Act increases the I.R.C. § 179 amount by the lesser of $100,000 or the cost of qualified GO Zone property placed in service by the taxpayer during the tax year. The Act also increases the $400,000 investment limitation by the lesser of $600,000, or the cost of qualified Go Zone property placed in service during the tax year. To be eligible, property must be purchased on or after August 28, 2005, and placed in service on or before December 31, 2007.

Environmental remediation. The Act extends I.R.C. § 198 expensing for two years. Thus, GO Zone taxpayers may expense some environmental remediation costs incurred in connection with qualified contamination sites located in the GO Zone through December 31, 2007. The Act also adds petroleum as a hazardous substance for this purpose.

Timber expensing. Taxpayers with aggregate holdings of qualified timber property that
do not exceed 500 acres at any time during the tax year in the Katrina, Wilma and GO Zones are permitted to double the otherwise allowable amount that can be expensed under I.R.C. § 194(b) for qualified timber property and can carry back timber net operating losses for five years.\(^7\)

**Casualty losses.** The Act removes the usual casualty loss restriction (10 percent of adjusted gross income and a $100 floor) for victims of hurricanes Rita and Wilma.\(^6\)

**Military personnel.** The Act extends for one year (through December 31, 2006) a provision contained in the Working Families Tax Relief Act of 2004 that permits military personnel to treat excludable combat pay as earned income for purposes of computing the earned income tax credit.\(^9\)

**Education credits.** The Act doubles the HOPE credit and the Lifetime Learning Credit for individuals who attend an eligible educational institution in the Katrina GO Zone for any tax year beginning in 2005 or 2006. Thus, the HOPE credit is increased to 100 percent of the first $2,000 in qualified tuition and related expenses and 50 percent of the next $2,000 of qualified tuition and related expenses for a maximum credit of $3,000 per student. The Lifetime Learning Credit rate is increased from 20 percent to 40 percent. In addition, certain room and board expenses qualify. Importantly, the credits are not limited to students who return to the GO Zone; students new to the area also qualify.\(^10\)

**Technical Corrections**

The Tax Technical Corrections Act of 2005 is contained in Title IV of the Act. The major focus of the corrections is on the 2004 Jobs Bill.

**Domestic production deduction.** The Act clarifies that companies that manufacture property for the federal government will qualify for the deduction and that any corporation that claims the deduction for income of a subsidiary must own more than 50 percent of the subsidiary.\(^11\) The Act specifies that a partnership and the members of an expanded affiliate group that own all the interests in the capital and profits of the partnership are treated as a single taxpayer.\(^12\) In addition, the Act clarifies that only one taxpayer can claim the deduction for the same economic activity, and that items of a partnership or other pass-through entity that arise in a tax year beginning before 2005 are not eligible for the deduction.\(^13\) As for the W-2 wage limitation, the Act clarifies that the limitation is based on wages actually paid and reported on an SSA-submitted Form W-2.\(^14\) The Act also clarifies that gross receipts from construction, engineering and architecture services must be derived in the ordinary course of the taxpayer’s active conduct of the trade or business.\(^15\) Income from the disposition of land is excluded from domestic production gross receipts.\(^16\)

**S corporation shareholder rules.** The Act repeals the requirement that a family must elect to be treated as one shareholder for purposes of determining the number of shareholders in an S corporation.\(^17\) The Act also provides that the determination of whether a common ancestor is more that six generations removed from the youngest generation of shareholders is made at the latest of (1) the date the subchapter S election is made; (2) the date a family member first holds stock in the S corporation; or (3) October 22, 2004.\(^18\) The Act provides that the estate of a family member is treated as a member of the family for purposes of determining the number of shareholders.\(^19\)

**Subsidiary liquidations.** The Act clarifies that on the tax-free liquidation of a corporate subsidiary, the fair market value basis rule applies only to property that became subject to U.S. income tax on the liquidation. The Act also provides that the election under I.R.C. § 362(e)(2)(C) to apply the basis limitation to the transferor’s stock basis is made at such time and in such form and manner as the Secretary may prescribe, and, once made, is irrevocable.\(^20\)

**Exclusion of gain on sale of principal residence.** The Act extends the rule under § 121(d), governing the exclusion from gross income of gain on the sale of a principal residence for property acquired in a like-kind exchange by clarifying that the five-year ineligibility period also applies to exchanges by the taxpayer or by any person whose basis in the property is determined by reference to the basis in the hands of the taxpayer (such as by gift).\(^21\)

**Substantiation of charitable contributions.** The Act adds to the substantiation requirement applicable to deductions taken for contributions of used motor vehicles, boats, and airplanes with a claimed value of over $500. The Act specifies that the written acknowledgement also must indicate whether the donee organization provided goods or services as consideration for the vehicle and must describe and provide a good faith estimate of the value of such goods and services or, if the goods or services consist solely of intangible religious benefits, provide a statement to that effect.\(^22\)

**Divisive reorganizations.** The Act clarifies that the adjusted basis of property taken into account for purposes of I.R.C. § 361(b)(3) is reduced by the liabilities assumed (within the meaning of I.R.C. § 357(c)). Section 361(b)(3) provides generally that, if a corporation receives money or property other than stock or securities in a tax-free reorganization and transfers the money or other property to its creditors in connection with the reorganization, the transfer to creditors is treated a “distribution in pursuance of the plan of reorganization” and, thus, tax free. AJCA added a sentence to I.R.C. § 361(b)(3) stating that this nonrecognition rule only applies in a divisive “D” reorganization to the extent that the sum of money and fair market value of the other property transferred to creditors does not exceed the adjusted bases of the assets transferred. The Act adds a parenthetical clarifying that the adjusted bases of those assets are reduced by the amount of liabilities assumed (within the meaning of I.R.C. § 357(c)). The Act also amends I.R.C. § 357(d)(1) to clarify that the I.R.C. § 357(d) rules on determining when a liability is assumed apply to I.R.C. § 361(b)(3).\(^23\)
Footnotes

2 Act, Sec. 101, adding I.R.C. § 1400M.
3 Act, Sec. 101, adding I.R.C. § 1400N(d). Applicable to property placed in service on or after August 28, 2005, in taxable years ending on or after such date.
4 Act, Sec. 101, adding I.R.C. §1400N(e). Effective for property placed in service on or after August 28, 2005, in tax years ending on or after such date.
5 Act, Sec. 101, adding I.R.C. § 1400N(g). Effective for tax years ending on or after August 28, 2005.
6 Act, Sec. 101, adding I.R.C. § 1400N(i)(1). Effective for tax years ending on or after August 28, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the GO Zone; effective for expenditures paid or incurred on or after September 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the GO Zone; effective for expenditures paid or incurred on or after October 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Wilma Zone.
7 Act, Sec. 101, adding I.R.C. § 1400N(i)(2). Effective for tax years ending on or after August 28, 2005, with respect to income and loss which are allocable to that portion of the taxpayer’s taxable year which is (i) on or after August 28, 2005 (for qualified timber property any portion of which is located in the Gulf Opportunity Zone), on or after September 23, 2005 (for qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the GO Zone), or on or after October 23, 2005 (for qualified timber property any portion of which is located in the Wilma Zone) and (iii) before January 1, 2007.
8 Act, Sec. 102, adding I.R.C. § 1400S(b). Effective upon enactment and applicable to losses related to Hurricane Rita arising on or after September 23, 2005, and to losses related to Hurricane Wilma arising on or after October 23, 2005.
10 Act, Sec. 102, adding I.R.C. § 1400O. Effective upon enactment.
20 Act, Sec. 403(b), amending I.R.C. § 1361(c)(1)(B).
22 Act, Sec. 403(dd), amending I.R.C. §§ 334(b) and 362(e)(1)(B). Effective as if included in AJCA.
23 Act, Sec. 403(ee), amending I.R.C. § 121(d)(10). Effective for sales or exchanges after October 22, 2004.
25 Act, Sec. 403(jj).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

AUTOMATIC STAY. The debtors filed for Chapter 7 and received a discharge of some but not all taxes. In the following year, the debtors’ income tax return contained a claim for a refund which was allowed by the IRS but was used to offset some of the discharged taxes, in violation of the discharge order. The debtors filed a motion to find the IRS in contempt and sought compensatory damages, emotional distress damages, punitive damages, attorneys’ fees and costs. The Bankruptcy Court awarded compensatory damages and damages for emotional distress and the IRS appealed. The appellate court reversed on the emotional damages award, holding that Section 106 did not waive the IRS’s sovereign immunity as to emotional distress damages. In re Torres, 2006-1 U.S. Tax Cas. (CCH) § 50,112 (1st Cir. 2005), rev’d and rem’d, 2004-2 U.S. Tax Cas. (CCH) § 50,379 (Bankr. 1st Cir. 2004).

CHILD TAX CREDIT. The debtors filed for Chapter 7 on October 25, 2004. The debtors timely filed their 2004 income tax return which claimed a refund, of which $69 came from the child tax credit and $1,931 came from the additional child tax credit. The court noted that the child tax credit was a non-refundable credit for which a refund would arise only to the extent of any tax owed and the additional child tax credit was a refundable credit which would be refunded even if no tax was owed. The