SELECTIVE SUMMARY OF TAX RECONCILIATION BILL AS OF MAY 11, 2006

On May 11, 2006, Congress sent to the President for signature a tax reconciliation bill. Selected highlights are summarized below.

TAX ISSUES NOT ADDRESSED. The tax reconciliation bill does **not** include extension of the research credit and numerous reforms relating to charities and charitable deductions, which are left for a "trailer" bill.

TAX CUTS. The tax reconciliation bill includes the following tax cuts:

- **Capital gains and qualified dividends.** The bill extends for two years, from the end of 2008 to the end of 2010, the 15% maximum tax rate on long-term capital gains and qualified dividends.

- **AMT.** For one year only, the bill raises exemptions to $62,550 for married taxpayers filing jointly and $42,500 for single filers and extends applicability of nonrefundable personal credits.

- **Capital Gains for Self-Created Musical Works.** Capital gains instead of ordinary income treatment is extended to self created musical works sold by the artist before January 1, 2011.

- **Amortization of Music and Music Copyright Costs.** For years beginning on or before December 31 2010, taxpayers who create or acquire music and music copyrights may elect to amortize over five years expenses otherwise eligible for amortization under the income forecast method for works placed in service after December 31, 2005.

- **Business Expensing.** The $100,000 limit on small business expensing of tangible personal property is extended through 2009.

- **Environmental Clean-up Funds.** After enactment, companies that contribute to a CERCLA environmental clean-up settlement fund established by federal court order before 2011 will not be taxable on earnings of the fund, provided a governmental entity controls expenditure of the fund and upon termination any remaining funds are distributable to such governmental entity.

- **Controlled Foreign Corporations.** Exemptions of foreign active financing and insurance income of controlled foreign corporations ("CFCs") are extended through December 31, 2008. A temporary simplified exemption for dividends, interest, rents and royalties received by CFCs from related foreign persons applies to CFC taxable years beginning after 2005 and before 2009.

OTHER CHANGES. The bill includes various "revenue raisers" and other business-related provisions:

- **Earnings Stripping.** "Earnings stripping" limitations on deductibility by corporations of interest on loans payable to or guaranteed by related foreign persons are expanded to cover interest payable by partnerships in which a corporation has a direct or indirect interest, effective for taxable years beginning on or after the date of enactment.

- **Cash Rich Corporate Spin-Offs; Simplified Active Business Test.** "Cash rich" spinoffs are to be restricted -- tax-free treatment is disallowed if (i) either the distributing corporation or the spun-off corporation is a "disqualified investment corporation" and (ii) a new shareholder directly or indirectly holds a 50% or greater interest after the transaction in any "disqualified investment corporation" (a corporation that directly or indirectly has cash and other liquid assets greater than 2/3 of its assets if the spin-off occurs within one year after enactment or 75% of all its assets thereafter). For spin-offs on or before December 31, 2010, the active trade or business requirement is tested on the basis of a corporation's separate affiliated group.

- **FIRPTA.** Foreign Investment in Real Property Tax Act ("FIRPTA") provisions are amended to prevent avoidance through use of tiered investment entities and wash sale transactions.

- **Tax-Exempt Entity Participation in Tax Shelters.** Tax-exempt entities that participate in certain tax shelter transactions are subject to excise tax equal to the greater of 75% of proceeds or 35% of net income attributable to the transaction (100% of net income if the participation was knowing). Officers, directors, trustees and other managers who approve participation by a tax exempt entity and know or have reason to know it is such a tax shelter transaction are subject to a penalty of $20,000 for each such approval.

- **Expatriates.** The foreign earned income exclusion is indexed for inflation beginning in 2006 rather than 2008; the base housing amount is adjusted to 16% of the exemption amount rather than 16% of the Grade GS-14, step 1 amount, and the housing exclusion generally is limited to 30% of the foreign earned income exclusion; and excluded amounts are taken into account to determine a taxpayer's marginal tax bracket.

- **Domestic production activities deduction.** Wages taken into account for purposes of this deduction may not exceed 50% of wages properly allocable to domestic production activities.

- **"Kiddie" tax.** Children under 18, not 14, will pay "kiddie" tax on unearned income after 2005.

The bill contains numerous other provisions. For more information, contact a member of the Tax, Employee Benefits and Estate Planning Practice Group of Sheppard, Mullin, Richter & Hampton LLP:

TRANSACTIONAL TAX TEAM:

John Bonn
(978) 594-0170

Amy Tranckino
(619) 338-6597

David Ulich
(213) 830-2020

Matthew Richardson
(213) 617-4222

Mindy Piatoff
(202) 772-5339

James Carreon
(213) 617-5475

Tim Barnes
(619) 338-6537

EMPLOYEE BENEFITS TEAM:

Martin Smith
(213) 617-5490

David Paik
(213) 617-4196

Michael Chan
(213) 617-5537

Michael Gerald
(213) 617-4183

ESTATE PLANNING TEAM:

Randy Godshall
(714) 424-8235

Nancy Reimann
(213) 617-4145

Nancy Howard
(213) 617-4171

Amy McEvoy
(213) 617-4159