



New Law Statistics:

- 32 hurricane-related tax breaks
- 15 tax changes with nationwide impact
- 29 changes affecting 2005 returns
- \$8.6 billion in available tax benefits
- \$6.8 billion upfront benefits
- Over 200 Tax Code revisions
- Fourth tax bill passed in 2005
- 10 tax acts corrected

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President Signs Legislation Expanding Hurricane Relief, Correcting '04 Jobs Act Glitches and More

Four months after Hurricane Katrina devastated New Orleans and the Gulf Coast, Congress has approved a second massive tax relief bill to help individuals and businesses recover. On December 16, 2005, the Senate and the House passed, by unanimous consent, the Gulf Opportunity Zone Act of 2005 (P.L. 109-135). President Bush promptly signed the bill into law on December 21, 2005.

The new law also contains a host of non-hurricane related provisions, including those that assist military families, facilitate tax shelter settlements, and revise prior legislative language affecting the increasingly-popular domestic manufacturing deduction, dividend relief for repatriated profits, and a dozen other tax bills reaching back almost 20 years.

Comment

The new law appropriates \$8.6 billion into regional reconstruction efforts. Many provisions are very similar to the tax incentives enacted after 9-11, including bonus depreciation and enhanced small business expensing, but with more tax relief targeted to individuals. The new law also extends some tax incentives in the Katrina Emergency Tax Relief Act of 2005 (KETRA) (P.L. 109-73) of September to victims of Hurricanes Rita and Wilma.

Gulf Coast tax relief. The new law creates new tax incentives that will accelerate recovery by:

- Creating special economic zones, the Katrina Gulf Opportunity (GO) Zone as well as Rita and Wilma GO Zones;

- Enacting 50-percent bonus depreciation related to rebuilding;
- Expanding Code Sec. 179 expensing for investments;
- Allowing a five-year net operating loss (NOL) carryback for investments;
- Enhancing the low-income housing and rehabilitation credits;
- Increasing the New Markets tax credits; and
- Expanding tax-exempt bond limits.

Impact

Most of the new law's tax incentives are available to any business that wants to invest in the Gulf Coasts; doing business previously in that area is not a prerequisite. When combined with local tax rebates and other incentives, startup and expanding businesses alike, the business climate will be very friendly in the Gulf Coast.

More than hurricane relief. The Senate added some noncontroversial provisions that might otherwise have languished. A package of expiring provisions and other fine-tuning measures includes extending through 2006 the election to treat combat pay as earned income for purposes of the earned income tax credit (EITC).

Most notable, however, are Technical Corrections that cover 10 tax acts going back as far as 1987 and make a number of law-changing amendments related to the *American Jobs Creation Act of 2004* (P.L. 108-357) (*2004 Jobs Act*).

Continued on page 2

Cost. The overall 10-year cost of the legislation is estimated at \$8.6 billion, with most of it accelerated into the first two years.

TAX RELIEF FOR BUSINESS

Katrina GO Zone

The Katrina GO Zone is the centerpiece of the new law. Businesses and individuals in the GO Zone are eligible for special tax incentives to help them rebuild their homes, jump-start their businesses, hire more workers, purchase inventory and equipment, and return life to normal.

Comment

The original House version of the Gulf Opportunity Zone Act specifically excluded some taxpayers from GO Zone benefits. Casinos, liquor stores, golf courses, country clubs, massage parlors, hot tub facilities, sun tan facilities, and racetracks were left out. The exclusion has been modified in the final bill. Hotels and restaurants, for example, are not excluded simply because they are attached to casinos.

Bonus depreciation

Bonus first-year depreciation, part of the 9-11 tax relief package, makes a re-appearance in the Gulf Opportunity Zone Act. The depreciation deduction under Code Sec. 167 is increased by 50 percent for one year for qualified GO Zone property.

Qualified Katrina GO Zone property means:

- Property described in Code Sec. 168(k)(2)(A)(i) (purchased software, leasehold improvements, covered property with a recovery period of 20 years or less, and certain equipment); or
- Certain nonresidential real property or residential rental property, substantially all of which is used in the Katrina GO Zone and is in the active conduct of a trade or business by a taxpayer in the Katrina GO Zone.

Original use of property in the GO Zone must start with the taxpayer on or

after August 28, 2005. As long as that requirement is met, the property can be used or new. The property must be acquired by the taxpayer by purchase on or after August 28, 2005, but only if no written binding contract for the acquisition was in effect before August 28, 2005.

Impact

Although a modified bonus depreciation was available nationwide after 9-11 to help put the national economy back on track quickly, the latest bonus depreciation is regional only.

“The Katrina Go Zone is the centerpiece of the new law.”

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.

Caution. *The new law excludes some property from this special tax treatment, including tax-exempt bond financed property. Special rules also apply for AMT purposes and recapture.*

Comment

Taxpayers can elect out of bonus depreciation.

Comment

The new law authorizes the Treasury Department to extend on a taxpayer-by-taxpayer basis the required date of placement in service of qualifying property.

Double business expensing

The regular Code Sec. 179 expensing deduction is \$100,000 beginning in 2003 through 2007. The new law increases the expensing limitation by the lesser of \$100,000, or the cost of qualified Code Sec. 179 Katrina Go Zone property. It also increases the \$400,000 investment limitation by the lesser of \$600,000, or the cost

of qualified Code Sec. 179 Katrina GO Zone property placed in service during the tax year. Property purchased on or after August 28, 2005, and placed in service on or before December 31, 2007, qualifies.

Impact

The actual dollar amounts are higher than those stated in the new law because the basic \$100,000 is inflation-indexed to \$108,000 in 2006. The additional Katrina GO Zone limit, however, is not indexed, making the total expensing for 2006 GO investments limited to \$208,000. Likewise, only the regular \$400,000 phase-out threshold on the acquisition of qualified property is indexed (\$430,000 in 2006). Therefore, the total GO Zone cap is \$1.03 million in 2006 for Katrina-related expenditures.

Comment

Under the regular Code Sec. 179 deduction, heavy-SUVs are limited to \$25,000. This limitation is unchanged by the new law.

Caution. *This more generous tax treatment is extended only to qualified Code Sec. 179 Katrina GO Zone property placed in service from August 28, 2005 through December 31, 2007. Expensing on property that ceases to be GO Zone property (that is, property moved out of the area) must be recaptured.*

Additional clean up/demolition expensing

The new law encourages clean up and demolition by allowing taxpayers to expense 50 percent of clean-up costs that otherwise would be required to be capitalized. Costs must be paid or incurred after August 27, 2005, and before January 1, 2008, for the removal of debris from, or the demolition of structures on, real property in the Katrina GO Zone.

Impact

The law does not limit this write-off to businesses that existed before the storm; the property may

be held for the production of income (investment) or inventory, as well as for use in a trade or business. Investors, therefore, can buy up properties, clean up and demolish with the help of the 50 percent deduction, and then flip the property for a hoped-for profit within a few years.

Environmental remediation expensing

The new law extends the Code Sec. 198 expensing provision two years. Taxpayers, therefore, may expense some environmental remediation costs incurred in connection with qualified contaminated sites located in the Katrina GO Zone through December 31, 2007. The new law also adds petroleum as a hazardous substance for this purpose. Special expensing of general remediation costs had been scheduled to end for expenditures paid or incurred on or before December 31, 2005.

The rehabilitation credit and Brownfields cleanup deduction are also enhanced for the Katrina GO Zone.

Timber expensing/carryback

Devastating blow-downs of trees on thousands of square miles especially impacted the Gulf timber industry, which for the most part is made up of small producers. Small timber producers owning fewer than 500 acres in the Katrina, Rita and Wilma GO Zones will be able to take advantage of a doubling of expensing for qualified timber property and a five-year "farming" carryback of specified timber net operating losses (NOLs).

Enhanced NOL carryback

The new law also enhances the carryback of some NOLs, which goes hand-in-hand with increased expensing. The new law allows taxpayers to carry back qualified NOLs five years instead of two.

Comment

A Senate summary of the new law explains that NOLs must be "attributable to new investment and repairing existing investment in the areas damaged by Hurricane Katrina; business casualty losses caused by Hurricane Katrina;

WHO GETS WHAT TAX RELIEF?

Hurricane tax relief under the new law is distributed based on residency and activity in the following designated areas:

Gulf Opportunity (GO) Zone- *That portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.*

Hurricane Katrina Disaster Area- *An area with respect to which a major disaster has been declared by the President before September 14, 2005 under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.*

Rita GO Zone- *Same criteria as GO Zone, but with Hurricane Rita rather than Hurricane Katrina the cause.*

Hurricane Rita Disaster Area- *Area declared by the President as a major disaster before October 6, 2005 under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason by reason of Hurricane Rita.*

Wilma GO Zone- *Same criteria as GO Zone, but with Hurricane Wilma rather than Katrina the cause.*

Hurricane Wilma Disaster Area- *Area declared by the President as a major disaster before November 14, 2005 Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason by reason of Hurricane Wilma*

and moving expenses and temporary housing expenses for employees working in the areas damaged by Hurricane Katrina." The IRS will no doubt issue guidance soon to explain the full scope of the provision.

Impact

Businesses considering entering the Gulf area for the first time also presumably can qualify to carryback any amount listed by the new law to offset income from prior year operations, whether within or outside of the area.

Comment

Taxpayers can irrevocably elect out of this special treatment. Careful planning is essential in deciding whether to make the decision to carry back or not carry back an NOL, considering such variables as the amount of any potential refunds generated by the carrybacks against future earnings.

Public utility casualty losses

Public utilities in the Katrina GO Zone are eligible for a 10-year carry back on casualty losses.

Employee retention credit

KETRA created a new tax credit to encourage small employers to keep employees on their payrolls. The credit is 40 percent of the first \$6,000 in wages paid to each eligible employee after August 28, 2005, and before January 1, 2006, by employers in the core disaster area, for the period the business is rendered inoperable as a result of damage caused by Hurricane Katrina.

The new law expands the employee retention credit in two ways. First, it is no longer limited to small employers (200 employees or less) and does so retroactively. Second, it also applies to employers affected by Hurricanes Rita and Wilma.

Comment

"Business owners have tapped into their savings to help out their workers. They deserve tax relief," Senator Max Baucus, D-Montana, said.

Caution. *KETRA also enhanced the Work Opportunity tax credit, creating a new target group for that credit (Hurricane Katrina employees). The new law does*

not extend this special treatment to businesses affected by Hurricanes Rita or Wilma.

Employer-provided housing

Under the new legislation, employers and employees get help with post-Katrina housing costs. Employees may exclude up to \$600 per month for qualified housing expenses provided by their employers. Housing must be located in the Katrina GO Zone. There are also residency requirements. In addition, employers can claim a tax credit of 30 percent of the excludable amount of housing help provided to employees (\$180/month maximum credit per subsidized employee).

Comment The period during which this tax break is available is limited to the first day of the first month after President Bush signs the legislation (likely to be January 1, 2006) and through the sixth month.

INVESTMENT INCENTIVES

New markets tax credit

The new law expands the new markets tax credit for the Katrina GO Zone. Community development entities (CDEs) are allowed an additional \$300 million in 2005 and 2006 and \$400 million in 2007.

Tax-exempt bonds

The new law authorizes the issuance of special tax-exempt and mortgage bonds to help finance recovery. The proceeds of "GO Zone" bonds must be used for qualified projects. The new law also allows one additional advance refunding for these bonds. Aggregate face-amount limits are substantial: \$7.9 billion for Louisiana, \$4.8 billion for Mississippi, and \$7.1 billion for Alabama.

Impact *As a big plus, interest payments on the bonds are not subject to the alternative minimum tax (AMT).*

Comment The states in turn may delegate authority to issue these bonds to their political subdivisions. However, to reduce instances in which unqualified use of proceeds results from issuers on the local level, the state bond commission or governor must directly approve the issue. Also, to prevent abuse, funding for movable equipment and fixtures is not permitted.

Tax-credit bonds

The new law also gives states a limited ability to pay out federal tax credits instead of interest to investors in "Gulf Tax Credit Bonds." This break will allow states to provide assistance to local governments unable to meet their debt service as the result of the hurricanes. Pass-through credits for partnerships and similar entities could be claimed by following current research-credit rules. The new law authorizes \$350 million in these bonds.

Helping homeowners rebuild

The new law expands the pool of individuals who qualify for help through state-issued tax-exempt mortgage revenue bonds. These bonds finance mortgages at lower interest rates. Under the new law, the first-time homeowner requirement is eased.

Low-income housing credit

The new law increases the state low-income housing credit ceiling. It also relaxes area gross median income determinations. For purposes of the credit, "difficult development areas" include the Rita GO Zone and the Wilma GO Zone in addition to Katrina-hit areas.

Operators of qualified residential rental projects also are given leeway to rely on representations of prospective tenants displaced by Katrina in determining whether the individuals satisfy the income limitations for qualified rental projects. It also provides a \$3.5 million increase in the credit cap for Texas and Florida.

EDUCATION CREDIT ENHANCEMENTS

The new law 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. The HOPE credit for qualifying students will be \$3,000 and the Lifetime Learning credit increases to a \$4,000 maximum. In addition, certain room and board expenses qualify.

Impact *Colleges and universities in New Orleans and along the Gulf Coast suffered extensive damage from Hurricane Katrina. Thousands of students were displaced to other schools. It is hoped that doubling these credits will persuade many temporary transfer students to return to the New Orleans and Gulf Coast. These credits are not limited to students who return; students new to the area also qualify.*

EXTENDING KATRINA RELIEF TO RITA AND WILMA VICTIMS

After Hurricane Katrina, Congress passed the *Katrina Emergency Tax Relief Act of 2005 (KETRA)*. KETRA targeted tax relief primarily to individuals. The new law extends some of the provisions in KETRA to victims of Hurricanes Rita and Wilma to help them recover. Congress also directed Treasury and the IRS to preserve tax benefits for victims of Hurricanes Rita and Wilma as it did for victims of Hurricane Katrina.

Comment The IRS has already extended many tax filing and payment deadlines for victims of Hurricanes Rita and Wilma. The new law codifies these changes.

Caution. Hurricanes Katrina, Rita and Wilma all hit the United States in rapid succession, with some localities hit by multiple storms. FEMA has designated wide swaths of Alabama, Florida, Louisiana, Mississippi, and Texas as disaster areas. The IRS has also designated areas in these states as eligible for different types of tax relief. Depending on where a taxpayer resides, relief may or may not be automatic. The IRS continues to refine its list of the hardest hit areas to determine areas eligible for the automatic relief. Before filing any returns, making any payments, or taking any other actions, taxpayers should check the IRS's web site for its most recent list of hardest hit areas.

Casualty losses

The new law lifts the usual casualty loss restrictions (10 percent of AGI and a \$100 floor) for victims of Hurricanes Rita and Wilma.

Impact Losses from Hurricanes Rita and Wilma are effectively treated as a separate deduction from all other casualty losses. Elimination of limitations also will likely mean larger refunds for Rita and Wilma victims who amend their 2004 returns.

Reminder. Taxpayers in presidentially-declared disaster areas have the option of deducting their casualty loss on the return for the year in which the loss occurred or the previous year's return.

Charitable giving

KETRA waived the 10-percent-of-taxable-income limitation on corporate donations for cash contributions made for Hurricane Katrina relief. The new law extends this treatment to corporate

donations of cash made for Hurricane Rita and Hurricane Wilma relief, effective for contributions made before January 1, 2006.

Comment For individuals, KETRA lifted the 50-percent AGI annual limit on charitable contributions made between September 1, 2005, and December 31, 2005. This special provision applied whether contributions by an individual were made to a hurricane-related charity or to any charitable organization or institution nationwide. The new law makes no further changes to this tax break.

Retirement plan distributions

KETRA relaxed the strict rules governing early distributions from retirement plans and IRAs. KETRA also made it easier for victims of Hurricane Katrina to borrow from their pension plans. Now, victims of Hurricanes Rita and Wilma are also eligible for this special treatment, up to a total of \$100,000 in distributions.

Impact The rules for early distributions are complex and the language in KETRA is equally complex. The IRS released Notice 2005-92 in November explaining how Hurricane Katrina victims can access their retirement savings. Generally, a "Katrina distribution" is not subject to the 10-percent penalty applicable to early distributions from a retirement plan. The distribution is included in income over a three-year period. To the extent the distribution is eligible for tax-free rollover treatment, and is re-contributed to an eligible retirement plan within the three-year period, it will not be included in income at all. Another provision in KETRA increases allowable plan loan amounts.

Quick Relief

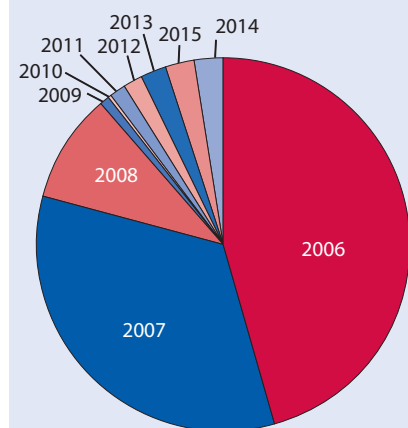
Unlike many recent tax laws that have doled out tax cuts and other breaks evenly over a 10-year "revenue projected" period, the Gulf Opportunity Zone Act of 2005 front loads its benefits principally into FYs 2006 and 2007 (12-month years ending June 30, 2006, and June 30, 2007, respectively).

TAX RELIEF FOR MILITARY PERSONNEL

The Working Families Tax Relief Act of 2004 (P.L. 108-311) gave military personnel the option of treating excludable combat pay as earned income for purposes of computing the earned income tax credit (EITC). This option applied for the 2004 and 2005 tax years only. The new law extends this special treatment for the 2006 tax year.

Impact Without this special treatment, a soldier or other military personnel, could have no earned income and, as a consequence, no refundable EITC because of the military pay exclusion.

Total Estimated Revenue Effect FY 2006-2015: \$8.668 Billion



REVENUE RAISERS

The new law is not revenue neutral. It spends significant amounts and generates almost no revenues, with no specific title of the new law designated as “revenue raisers.” Only two provisions are projected to bring money into the Treasury: \$50 million over 10 years for the interest suspension rules and less than \$0.5 million for extension of undercover-operations authority.

Interest on tax shelters

To curb the growth of tax shelters, the IRS has offered investors the chance to come forward and participate in its new global tax shelter settlement initiative. While investors and other taxpayers may be eligible for a special interest suspension if the IRS doesn’t make an assessment fast enough (18 months), Congress in 2004 removed that eligibility for certain tax shelter deficiencies. Unwittingly, however, that suspension hamstrings the IRS in trying to settle certain tax shelter cases.

The new law makes three changes to set things right:

- The elimination of interest suspension is expanded to include pre-October 3, 2004 interest, totally eliminating the interest suspension break for many tax shelters;
- An exception to the elimination of interest suspension is allowed for those now participating in the IRS’s tax-shelter global settlement initiative, as well as those for whom IRS decides that reasonable cause and good faith exist; and
- The elimination of interest suspension on tax amended returns.

Undercover operations

The new law extends for one more year the IRS’s ability to use income from an undercover investigation to pay additional expenses incurred in conducting such an investigation.

Disclosure of return information

The IRS is permitted to disclose taxpayer return information only in limited circumstances. After 9-11, Congress authorized the IRS to share return information to investigate terrorism. This special treatment is temporary. The new law extends it for one more year (through December 31, 2006). Congress estimates it will have no revenue effect.

TECHNICAL CORRECTIONS

The *Tax Technical Corrections Act of 2005* is in Title IV in the new law. Title IV includes technical corrections to 10 major tax acts, from the *Omnibus Budget Reconciliation Act of 1987* to the *Energy Policy Act of 2005*. Its major focus, however, is correcting and clarifying the *2004 Jobs Act*.

Impact *In sheer size, the technical corrections make up over half the pages in the official copy of the new law. In scope, its changes impact more taxpayers because the technical corrections are not limited to Katrina relief.*

Comment Senate Finance Committee Chairman Charles Grassley, R-Iowa, and Ranking Member Max Baucus, D-Montana, said that technical corrections are “necessary to ensure that laws are working consistently with the originally enacted provisions.”

Domestic manufacturing deduction

Under Code Sec. 199, a business can take a deduction of 3 percent (in 2005 and 2006, eventually rising to 9 percent in 2010) of qualified production activities income (QPAI) from sales of U.S. property and services. So pressing were many of the technical corrections

for this new deduction that Congressional tax leaders wrote to Treasury Secretary John Snow in July promising to make several critical changes. The following technical corrections are among those that made good on Congress’ promise:

- Companies that manufacture property for the federal government will qualify for the deduction;
- A corporation that claims the deduction for income of a subsidiary must own more than 50 percent of the subsidiary;
- A partnership and the members of an expanded affiliated group that owns all the interests in the capital and profits of the partnership are treated as one taxpayer;
- More than one taxpayer cannot claim the deduction for the same economic activity;
- Items of a partnership or other pass-through entity that arise in a tax year beginning before 2005 cannot be counted;
- The Form W-2 wage limitation on the deduction is based on wages actually paid and reported on an SSA-submitted Form W-2;
- 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;
- Income from disposition of land is excluded from gross receipts; and
- For partnerships and S corps, rules for calculating the deduction at the partner or shareholder level are clarified.

Nonqualified deferred compensation

Code Sec. 409A imposed tough new restrictions on the deferral of compensation. There is one further restriction added by the technical corrections. Amounts in an offshore trust or amounts in a “rabbi” trust (available to creditors only if the employer has financial problems) are

taxable. As a safety valve, however, the Treasury Department is directed to issue regulations that allow plans to cure these defects.

Caution. Unlike other provisions that apply to amounts deferred after December 31, 2004, this provision will apply to existing deferrals in place on or after January 1, 2005.

Dividends repatriation

Code Sec. 965 provides a one-time 85 percent dividends received deduction for dividends paid by a controlled foreign corporation to its domestic parent. Since the *2004 Jobs Act* provided a short one-year window in which corporations could arrange for this special tax break, the IRS released guidance that anticipated passage of the new law's technical corrections provisions. The technical corrections take care of many

glitches, oversights, and loopholes in the rules, including those fixed by adding the following rules:

- The Code Sec. 78 gross-up rules do not apply to foreign taxes that are not creditable under the 85-percent dividends received deduction;
- The disallowance of the deduction for expenses applies only to expenses directly related to the income being repatriated;
- Financial statements (including integral notes but not workpapers) used to determine the limit on repatriated amounts must be the most recent audited annual statement filed and certified on or before June 30, 2003;
- Elections to claim the repatriation deduction may be made *on* or before the due date for filing a tax return for the particular year, not just before the due date; and

- Only cash dividends may be counted in determining excess dividends.

Other Technical Corrections

Additional technical corrections reach all the way back to 1987. Some of the more major "corrections" include:

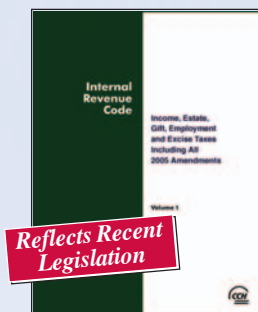
- Repealing the requirement that families must elect to be treated as one S corporation shareholder.
- Treating the estate of a family member as a member of a family for S shareholder limitations;
- Application of the suspended loss rules for S stock transfers between spouses to transfers after December 31, 2004;
- Procedures for REITs to cure *de minimis* asset-requirement failures;
- Application of an episode-by-episode test for the expensing of qualified film or TV production costs; and
- Clarification that the state and local tax itemized deduction does not apply in computing AMT.

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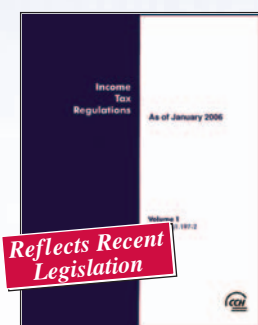
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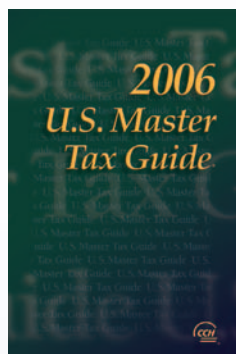


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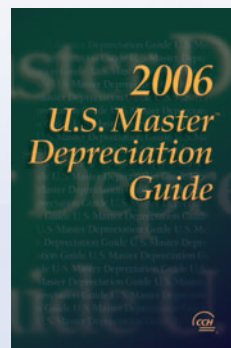
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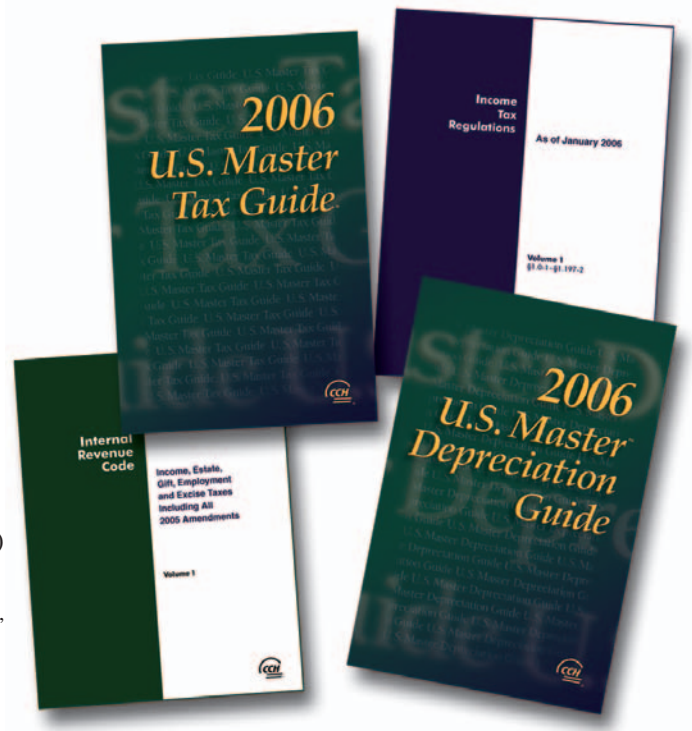


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