

## MEMORANDUM

To: Financial Advisors and Development Executives

From: The Sharpe Group

Re: KATRINA TAX ACT UPDATE

Date: November 23, 2005

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On Friday, September 23, President Bush signed into law the *Katrina Emergency Tax Relief Act of 2005* (KETRA). In the ensuing weeks, there has been much discussion of the Act and what impact it may or may not have on giving this fall. In this memorandum, we offer a brief overview of what we believe to be the relevant provisions of the legislation and offer suggestions that may be helpful as clients and donors consider their philanthropic planning for the remainder of this year.

KETRA features a number of tax incentives for those directly impacted by the destruction of Hurricane Katrina as well as those individuals and businesses that provide aid. Such provisions include:

- Deductions for those providing shelter to victims
- Special rules for victims deducting losses
- No tax on debt forgiveness
- Low-interest mortgages
- Penalty-free retirement fund withdrawals for victims
- Extension of tax deadlines for those directly affected
- Tax deductions for vehicle use in aiding victims
- Special tax incentives for businesses to donate books and food
- Tax incentives for employing victims
- Small business tax credits
- Other incentives for charitable gifts

### **Important charitable giving incentives**

In addition to the measures aimed to assist disaster victims, KETRA also temporarily suspends otherwise applicable limits on charitable deductions for individuals and corporations. In the case of *corporations*, the 10% of taxable income limit is waived for contributions to organizations that are providing relief to those affected by Hurricane Katrina. (Relevant portions of the Act and Technical Explanation are attached as Addenda A and B)

There are even more generous provisions for individual taxpayers. Under regular federal tax law, itemized deductions for individuals making gifts of cash and certain other property are limited to 50% of their “contribution base” (Adjusted Gross Income without regard to loss carrybacks – hereinafter referred to simply as AGI). For gifts of appreciated assets, the limit is normally 30% of AGI. KETRA suspends the 50% of AGI limit for “qualified gifts” of cash. Such gifts will be deductible in amounts up to 100% of AGI. Carryover provisions apply for gifts in excess of these amounts. For examples of specific situations and carryover rules, see the Joint Committee on Taxation explanation of the bill. The full Joint Committee report and the text of the bill can be accessed via [www.sharpenet.com/ketra/](http://www.sharpenet.com/ketra/).

“Qualified gifts” are defined as gifts of *cash* that are completed during the period beginning on August 28, 2005 and ending on December 31, 2005. These gifts must be made to charities that qualify for contributions under Section 170(b)(1)(A) of the Internal Revenue Code. **NOTE: KETRA does NOT require that charities receiving gifts from individuals be engaged in providing direct relief to Katrina victims.**

In fact, it is clear that Congress intended to encourage donors to continue supporting other charitable interests in addition to their gifts for relief efforts. In a press release from the Senate Finance Committee on September 20, 2005, Senator Charles Grassley of Iowa, Chairman of the Committee, stated “*We also need to make sure the national economy stays strong in light of high energy prices and other uncertainties. Also, with many of the charitable provisions in the tax bill, our goal is to encourage charitable giving outside of Katrina relief to prevent the rest of the nation’s charities from seeing a downturn in giving as they did after Sept. 11.*” Senator Grassley reiterated these remarks in the article entitled “In Hurricane Tax Package, a Boon for Wealthy Donors,” published in the New York Times on October 27, 2005.

Gifts to donor advised funds, most private foundations, supporting organizations, most charitable remainder trusts, and certain other life income gift plans, however, are excluded from the definition of “qualified gift.” Because amounts used to fund charitable gift annuities are transferred directly to qualified charities, subject to a reduction in the donor’s charitable deduction equal to the value of the annuity interest, it appears such gifts may be considered “qualified gifts” under the terms of KETRA. A prospective donor should, as in other matters related to their charitable planning, seek advice of counsel before funding a gift annuity where it is anticipated the charitable deduction will exceed normal AGI limits.

A simplified example may be helpful. Suppose an individual with a significant net worth has an AGI for 2005 of \$200,000. They have recently sold securities, have several hundred thousand dollars in cash in a money market account, and have an outstanding pledge of \$200,000 to a campaign. If they made a cash gift of \$200,000 this year, they could ordinarily deduct 50% of that amount, or \$100,000. Under the provisions of KETRA, they could deduct the entire \$200,000 for federal income tax purposes if the gift was made between August 28, 2005 and December 31, 2005. State income tax laws should also be considered when planning such gifts.

In addition to suspending the 50% of AGI limit for qualified gifts of cash between August 28 and the end of the year, the provision in the internal revenue code that requires the reduction of itemized deductions (including charitable gifts) by 3% of the amount by which AGI exceeds \$145,950 (\$72,975 for married persons filing separately) is also waived for qualified gifts.

### **Who is affected?**

One might ask, “What difference might KETRA make? How many donors actually exceed the 50% of AGI limit and/or are subject to the 3% reduction rules?” While this situation may be relatively uncommon, those who *are* affected are often among the wealthiest and most generous donors. It is not uncommon for a development officer or a volunteer to hear from a donor, “My accountant says I can’t give any more this year.” What donors may mean, whether they realize it or not, is that they have run up against AGI limits and/or the 3% reduction rule. This is not unusual for those of significant wealth but relatively low income. Keep in mind that tax exempt income, social security benefits for many taxpayers, amounts paid as alimony, and certain expenses are not included in AGI.

IRS reports for the 2002 tax year shed light on how many persons may be affected. These reports revealed that charitable deductions that year totaled some \$140 billion. Carryforward amounts were reported by 428,835 taxpayers. They reported \$37.8 billion in the form of charitable gifts carried forward from one or more prior years when they had made gifts in excess of what they could deduct due to AGI limits. The breakdown of the 428,835 taxpayers by their AGI amount is informative.

AGI	Number of Returns
<\$50K	261,114
\$50K-\$199K	135,641
>\$200K	32,079
Total	428,835

Note the vast majority of those who had carryforward amounts because they had exceeded AGI limits in prior years had an AGI of less than \$200,000. To review the data for charitable deductions carried forward in 2002, see <http://www.irs.gov/pub/irs-soi/02in03ga.xls>.

### **Other indirect benefits of KETRA**

KETRA contains other possible incentives for charitable giving. Through waiving the limits on AGI and reduction of itemized deductions, Congress has indirectly made possible some of the benefits for outright gifts from retirement funds that would have been allowed had the pending CARE Act been included as part of the bill.

Take, for example, the case of a 72-year-old retired couple with total assets of \$5 million. Their adjusted gross income is \$250,000, and they have an IRA that is worth \$1.5 million. They are being forced to take mandatory withdrawals from their IRA each year and pay tax on income they don't need. They would like to use \$600,000 of their IRA funds to fulfill an outstanding pledge. Under current law without regard to KETRA, if they withdrew the funds they would have a new AGI of \$250,000 + \$600,000, or \$850,000. They would then be allowed to deduct 50% of that amount, or \$425,000. The difference between the \$600,000 withdrawn and the \$425,000 that was deductible, or \$175,000, would be taxable. Additionally, the \$425,000 charitable deduction would be reduced by \$12,750 under the 3% reduction rule. Consequently, donors who find themselves in this position may decide not to make such a gift.

The CARE Act, if enacted, would allow this couple to make their \$600,000 gift directly to charity without incurring the limitation and reductions described above. Similarly, under the provisions of KETRA, between now and the end of the year the couple will be able to withdraw the entire \$600,000 and give it all to any qualified charity (regardless of whether it is aiding Katrina victims). Because the 50% of AGI limitation and 3% reduction rules are suspended for the remainder of the year for qualified gifts, the entire \$600,000 is deductible and not subject to the 3% reduction rule. That is why for some donors the KETRA bill essentially makes possible for federal tax purposes what the CARE Act would have allowed, albeit on a temporary basis.

Significant distinctions, however, should be drawn between what KETRA accomplishes and what the CARE Act would have accomplished. Among the key differences:

- The CARE Act would only apply to gifts from Individual Retirement Accounts (IRAs). KETRA is not limited to withdrawals from IRAs but serves to facilitate gifts from 401(k)s and other qualified retirement plans as well.
- The CARE Act would allow donors over the age of 59 ½ to fund gift annuities, charitable remainder trusts, and pooled income funds using assets from their IRA. The CARE Act would also allow outright gifts only if an individual was beyond the age of 70 ½. KETRA does not allow gifts directly to life income gift plans without incurring tax consequences but effectively lowers the age for outright gifts funded with amounts withdrawn from retirement accounts to include those over age 59 ½.
- The CARE Act would not require amounts directed from an IRA to charity to be reported as income. KETRA requires the amounts to be reported as part of AGI and, by “swelling” a taxpayer’s AGI, may result in the partial loss of other federal tax exemptions and deductions that are reduced as AGI increases.

- The CARE Act would be permanent. KETRA is only applicable to gifts made on or after August 28 and by December 31, 2005.

It is also important to note that state income tax laws vary, and withdrawals from retirement plans that result in more adjusted gross income may, for example, serve to increase a donor's state income tax. Individuals should, as always, be urged to check with their tax and other financial advisors before taking a retirement plan withdrawal to fund a charitable gift.

The press has reported on the retirement fund giving aspect of KETRA. Some have referred to this as the provision that could result in the greatest influx of funds to nonprofits. In an article published on September 25, 2005, the *San Francisco Chronicle* observed that “[KETRA] raises the maximum deduction for qualified charitable contributions to 100 percent of adjusted gross income from 50 percent (excluding net operating loss carrybacks). Nonprofits are hoping this could unleash a flood of donations from Individual Retirement Accounts.” There have also been articles in the *New York Times* (October 27), *Forbes* (November 14 issue), *The Chronicle of Philanthropy* (October 13) and other publications about the charitable giving opportunities under KETRA.

Some potential donors of gifts funded with retirement plan withdrawals are the same persons who believe they may continue to be subject to estate taxes. They can thus anticipate both estate and income taxes being exacted from heirs who inherit their retirement plan balances. For such donors, KETRA presents a narrow window of opportunity to make relatively tax-free charitable gifts from their retirement plan balances.

### **Alternative sources of cash**

Those donors who would like to make larger gifts before the end of the year but lack sufficient liquid cash and decide not to use retirement funds to make their gifts may want to consider selling securities that have declined in value while they have owned them, deduct their losses to the extent possible, and use their cash proceeds to make gifts that would be exempt from the 50% of AGI limit.

Other donors may decide that it makes sense from a tax planning perspective to sell appreciated securities, report the capital gain portion as part of their AGI, and donate all or part of the cash proceeds. The result could be to offset the gain from the sale as well as other income that would otherwise be taxable. As in all tax matters, donors should be urged to consult with their professional advisors before deciding the best source of cash for use in making donations this fall.

## Conclusion

While KETRA did not include a number of benefits that would be afforded under the CARE Act, it offers an opportunity for charitably inclined individuals. Thus, many advisors and nonprofits will want to identify those who they believe **can** benefit from KETRA's provisions and make them aware of the opportunities to make significant tax-favored gifts between now and the end of this year.

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## **Addendum A**

### **TITLE III--CHARITABLE GIVING INCENTIVES**

#### **SEC. 301. TEMPORARY SUSPENSION OF LIMITATIONS ON CHARITABLE CONTRIBUTIONS.**

(a) In General- Except as otherwise provided in subsection (b), section 170(b) of the Internal Revenue Code of 1986 shall not apply to qualified contributions and such contributions shall not be taken into account for purposes of applying subsections (b) and (d) of section 170 of such Code to other contributions.

(b) Treatment of Excess Contributions- For purposes of section 170 of such Code--

(1) INDIVIDUALS- In the case of an individual--

(A) LIMITATION- Any qualified contribution shall be allowed only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's contribution base (as defined in subparagraph (F) of section 170(b)(1) of such Code) over the amount of all other charitable contributions allowed under such section 170 (b)(1).

(B) CARRYOVER- If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(1) of such Code) exceeds the limitation of subparagraph (A), such excess shall be added to the excess described in the portion of subparagraph (A) of such section which precedes clause (i) thereof for purposes of applying such section.

(2) CORPORATIONS- In the case of a corporation--

(A) LIMITATION- Any qualified contribution shall be allowed only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's taxable income (as determined under paragraph (2) of section 170(b) of such Code) over the amount of all other charitable contributions allowed under such paragraph.

(B) CARRYOVER- Rules similar to the rules of paragraph (1)(B) shall apply for purposes of this paragraph.

(c) Exception to Overall Limitation on Itemized Deductions- So much of any deduction allowed under section 170 of such Code as does not exceed the qualified contributions paid during the taxable year shall not be treated as an itemized deduction for purposes of section 68 of such Code.

(d) Qualified Contributions-

(1) IN GENERAL- For purposes of this section, the term 'qualified contribution' means any charitable contribution (as defined in section 170(c) of such Code)--

(A) paid during the period beginning on August 28, 2005, and ending on December 31, 2005, in cash to an organization described in section 170(b)(1)(A)

of such Code (other than an organization described in section 509(a)(3) of such Code),

(B) in the case of a contribution paid by a corporation, such contribution is for relief efforts related to Hurricane Katrina, and

(C) with respect to which the taxpayer has elected the application of this section.

(2) EXCEPTION- Such term shall not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor.

(3) APPLICATION OF ELECTION TO PARTNERSHIPS AND S CORPORATIONS- In the case of a partnership or S corporation, the election under paragraph (1)(C) shall be made separately by each partner or shareholder.

## **Addendum B**

### **TITLE III – CHARITABLE GIVING INCENTIVES**

#### **A. Temporary Suspension of Limitations on Charitable Contributions (sec. 301 of the bill)**

##### **Present Law**

##### **In general**

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

##### **Percentage limitations**

##### **Contributions by individuals**

For individuals, in any taxable year, the amount deductible as a charitable contribution is limited to a percentage of the taxpayer's contribution base. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. The contribution base is defined as the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

Contributions by an individual taxpayer of property (other than appreciated capital gain property) to a charitable organization described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private nonoperating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

### Contributions by corporations

For corporations, in any taxable year, charitable contributions are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating loss or capital loss carrybacks.

For purposes of determining whether a corporation's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions.

### Carryforward of excess contributions

Charitable contributions that exceed the applicable percentage limitation may be carried forward for up to five years (sec. 170(d)). The amount that may be carried forward from a taxable year ("contribution year") to a succeeding taxable year may not exceed the applicable percentage of the contribution base for the succeeding taxable year less the sum of contributions made in the succeeding taxable year plus contributions made in taxable years prior to the contribution year and treated as paid in the succeeding taxable year under this provision.

### **Overall limitation on itemized deductions ("Pease" limitation)**

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's adjusted gross income in excess of a certain threshold. The otherwise allowable itemized deductions may not be reduced by more than 80 percent. For 2005, the adjusted gross income threshold is \$145,950 (\$72,975 for a married taxpayer filing a joint return). These dollar amounts are adjusted for inflation.

The otherwise applicable overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation is repealed for taxable years beginning after December 31, 2009, and reinstated for taxable years beginning after December 31, 2010.

### **Explanation of Provision**

#### **Suspension of percentage limitations**

Under the provision, in the case of an individual, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years as contributions described in 170(b)(1)(A), subject to the limitations of section 170(d)(1)(A)(i) and (ii).

In the case of a corporation, the deduction for qualified contributions is allowed up to the amount by which the corporation's taxable income (as computed under section 170(b)(2)) exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years, subject to the limitations of section 170(d)(2).

In applying subsections (b) and (d) of section 170 to determine the deduction for other contributions, qualified contributions are not taken into account (except to the extent qualified contributions are carried over to succeeding taxable years under the rules described above).

Qualified contributions are cash contributions made during the period beginning on August 28, 2005, and ending on December 31, 2005, to a charitable organization described in section 170(b)(1)(A) (other than a supporting organization described in section 509(a)(3)). Contributions of noncash property, such as securities, are not qualified contributions. Under the provision, qualified contributions must be to an organization described in section 170(b)(1)(A); thus, contributions to, for example, a charitable remainder trust generally are not qualified contributions, unless the charitable remainder interest is paid in cash to an eligible charity during the applicable time period. In the case of a corporation, qualified contributions must be for relief efforts related to Hurricane Katrina. Corporate taxpayers must substantiate that the contribution is made for this purpose. A taxpayer must elect to have the contributions treated as qualified contributions.

Qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor. For example, a segregated fund or account exists if a donor makes a charitable contribution and the donee separately identifies the donor's contribution on its books by reference to the donor. The donor has advisory privileges with respect to such segregated fund or account if the donor, by written agreement or otherwise, is permitted to provide advice to the donee as to the investment or distribution of amounts from such fund or account. In addition, a segregated fund or account also includes, but is not limited to, a separate bank account or trust established or maintained by a donee; however, in order for a contribution to such account or fund necessarily to be not a qualified contribution, the donor (or a person appointed or designated by the donor) must have or reasonably expect to have advisory privileges as to the investment or distribution of amounts in such account or fund. For instance, a donor reasonably expects to have advisory privileges with respect to contributions made by the donor if the donor understands that the donee will consider advice provided by the donor (or a person appointed or designated by the donor) in making investments or distributions. It is intended that a person shall not be treated as having advisory privileges by virtue of having a legal or contractual right or obligation, or a fiduciary duty, with respect to a segregated fund or account. If a donor makes a contribution for establishment of a new, or maintenance in an existing, segregated account or fund, and the donor also provides advice with respect to amounts in such account or fund by reason of the donor's position as an officer, employee, or director of the donee, and not by reason of the donor's status as a donor, then, under the provision, the donor is not treated as having or reasonably expecting to have advisory privileges with respect to such fund or account. However, if by reason of a donor's charitable contribution to a segregated account or fund, the donor secured, for example, an appointment on a committee of the donee organization that advised how to distribute or invest amounts in such account or fund, the contribution would not be a qualified contribution notwithstanding that the donor is an officer, employee, or director of the donee organization.

Below are examples illustrating the operation of the provision. (The examples assume the taxpayer makes an election to have the provision apply.)

Example 1.—Assume individual A's contribution base for 2005 is \$100,000; aggregate qualified contributions are \$70,000; and other charitable contributions to organizations described in section 170(b)(1)(A) are \$60,000. Under the provision, A is allowed a deduction of \$100,000 for 2005 (\$50,000 determined without regard to qualified contributions plus \$50,000 for the qualified contributions). \$30,000 is treated as a contribution described in section 170(b)(1)(A) paid in each of the five succeeding taxable years (subject to the limitations of section 170(d)(1)(A)(i) and (ii)). \$30,000 is the sum of the \$10,000 excess referred to in section 170(d)(1)(A) (the excess of \$60,000 over \$50,000) and the \$20,000 excess referred to in section 301(b)(1)(B) of the bill (the excess of \$70,000 over \$50,000).

Example 2.—For calendar year 2005, B, an individual, has a contribution base of \$100,000. On January 10, 2005, B makes a \$7,000 cash contribution to an organization described in section 170(b)(1)(A) and a \$65,000 cash charitable contribution to an organization not so described. On October 10, 2005, B makes a \$70,000 qualified contribution. In 2004, B made charitable contributions to organizations described in section 170(b)(1)(A) that exceeded 50% of the contribution base by \$5,000.

First, subsections (b) and (d) of section 170 are applied by disregarding the qualified contribution. For 2005, a \$12,000 deduction is allowed under section 170(b)(1)(A)—the \$7,000 current year contribution and the \$5,000 carryover from 2004. For 2005, a \$30,000 deduction for the contribution to the organization not described in section 170(b)(1)(A) also is allowed. This amount is the lesser of (i) \$38,000 (\$50,000 (50% of B's contribution base) less the \$12,000 allowed under section 170(b)(1)(A)) or (ii) \$30,000 (30 percent of B's contribution base). The remaining contribution amount of \$35,000 is carried over as a contribution to an organization which is not described in section 170(b)(1)(A). Thus, without regard to the qualified contribution, B is allowed a total contribution deduction of \$42,000 in 2005.

In addition, B may deduct \$58,000 of the qualified contribution in 2005 (the lesser of (i) the \$70,000 amount of the qualified contribution or (ii) the \$58,000 excess of B's \$100,000 contribution base over the \$42,000 amount otherwise deductible). \$12,000 is treated as a contribution described in section 170(b)(1)(A) paid in each of the five succeeding taxable years (subject to the limitations of section 170(d)(1)(A)(i) and (ii)).

In summary, B's deduction for 2005 is \$100,000; \$12,000 may be carried over as a contribution to an organization described in section 170(b)(1)(A) (subject to the limitations of section 170(d)(1)(A)(i) and (ii)); and \$35,000 may be carried over as a contribution to an organization not so described (subject to similar limitations).

Example 3.—Assume corporation X's taxable income (as defined in section 170(b)(2)) for 2005 is \$100,000; aggregate qualified contributions (which, in the case of a corporation, must be related to Hurricane Katrina relief efforts) are \$100,000; and other charitable contributions are \$20,000. Under the provision, X is allowed a deduction of \$100,000 for 2005 (\$10,000 determined without regard to qualified contributions plus \$90,000 for the qualified contributions). \$20,000 is deductible in each of the five succeeding taxable years (subject to the

limitations of section 170(d)(2)(A)(i) and (ii). \$20,000 is the sum of the \$10,000 excess referred to in section 170(d)(2)(A) (the excess of \$20,000 over \$10,000) and the \$10,000 excess referred to in section 301(b)(2)(B) of the bill (the excess of \$100,000 over \$90,000).

**Limitation on overall itemized deductions**

Under the provision, the charitable contribution deduction up to the amount of qualified contributions (as defined above) paid during the year is not treated as an itemized deduction for purposes of the overall limitation on itemized deductions.

**Effective Date**

The provision is effective on the date of enactment.