[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

March 18, 2002

U.S. Government Printing Office
Washington: 2002

JCS-3-02

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107TH CONGRESS, 2ND SESSION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions and other provisions modifying the Internal Revenue Code (the "Code") that are contained in the President's fiscal year 2003 budget proposal, as submitted to the Congress on February 4, 2002.[2] The pamphlet generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's proposals.[3] For these provisions, there is a description of present law and the proposal (including effective date), an analysis of complexity and policy issues related to the proposal, and a reference to any prior budget proposal submission or recent legislative action.

Subsequent to the submission of the President's budget to Congress, provisions similar or identical to several of the budget proposals have been enacted into law (P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," as passed by the House of Representatives on March 7, 2002, by the Senate on March 8, 2002, and signed into law on March 9, 2002).

The President's budget refers to a "bipartisan economic security plan"[4] in assessing the impact of the budget on the Federal fiscal surplus or deficit; a detailed description of the plan is not included in the budget documents. Similarly, this pamphlet does not provide a description.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2003 Budget Proposal* (JCS-3-02), March 18, 2002.

[2] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003: Analytical Perspectives* (H. Doc. 107-159, Vol. III), pp. 55-83.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2003 Revenue Proposals*, February 2002.

[4] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003, Summary Tables: Table S-3, Impact of Budget Policy on the Surplus* (H. Doc. 107-159, Vol. I), p. 397.

I. SUMMARY OF COMPLEXITY ISSUES

It is generally acknowledged that complexity in the Federal tax system is a large and growing problem. The President's fiscal year 2003 budget acknowledges this and indicates that the Administration is developing simplification proposals.[5] The Administration indicates that this tax simplification project is focused on the following particular provisions: individual and corporate alternative minimum tax, family related provisions such as the earned income credit and the refundable child credit, differing rules regarding the definition of a child, income-based phaseouts, education incentives, Individual Retirement Accounts (IRAs), individual capital gains, excise taxes, tax-exempt bond arbitrage and private activity rules, asset depreciation classes and placed-in-service conventions, capitalization issues, international tax issues, and tax accounting issues such as accrual and inventory accounting, uniform capitalization rules, and percentage of completion method.

Complexity in the Federal tax system poses many problems. Among the more commonly recognized effects of complexity are (1) decreased levels of voluntary compliance; (2) increased costs for taxpayers; (3) reduced perceptions of fairness in the Federal tax system; and (4) increased difficulties in the administration of tax laws. Costs for taxpayers include the time to learn the tax laws, the time to fill out the necessary forms, and the costs of tax planning to secure certain tax benefits or favorable tax treatment and to avoid unfavorable tax treatment. Costs to society as a whole include these personal costs, as well as potential costs from beneficial activities, transactions, or investments that are forgone due to complex or uncertain tax treatment. Reduced perceptions of fairness in the Federal tax system may arise when complexity creates disparate treatment of similarly situated taxpayers. Disparate treatment arises (1) when taxpayers can't comprehend the law and don't have access to sophisticated tax advice; (2) when taxpayers have different interpretations of the law (which may be influenced by access to professional advice); and (3) when interactions among provisions create unintended consequences. Decreased levels of voluntary compliance are likely the direct result of the difficulties of complying with a complex system, even for those who wish to comply with the law. Additionally, the financial and other costs of compliance and the decreased perceptions of fairness that result from complexity are likely to contribute to taxpayers intentionally failing to comply with the tax law.

Though complexity is an undesirable feature of a tax system, many believe that complexity is an inherent feature of a tax system in a modern economy with individuals who have complex financial and economic situations as well as diverse family arrangements and responsibilities. A tax system that addresses these and other special circumstances, or that creates incentives for particular activities, will necessarily be complex. Nonetheless, most would agree that some complexity could be removed from the tax system without harm to the principal policy objectives of the tax system. Further, many would agree that complexity concerns should be balanced against other policy objectives, and that some desirable policies should not be pursued, or at least not pursued through the tax system, if the resulting tax provisions would be too complex.

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[5] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003: Analytical Perspectives* (H. Doc. 107-159, Vol. III), p. 75.

Notwithstanding the Administration's acknowledgement of the problem of complexity, the budget proposal itself is dominated by proposals that would at least modestly increase the complexity of the Code, rather than reduce it. Compared to other budget submissions in past years, the complexity that would be added is not unusual. It has been common in recent years for the President's budget proposals to include numerous tax incentives or benefits for both individuals and corporations in the form of special rules and new credits, deductions, or exclusions for a favored activity or situation. While the President's proposals include some provisions that would decrease the complexity of the Code (such as reforming the excise tax based on investment income of private foundations and revising the tax treatment of charitable remainder trusts), and others that would have no significant impact on complexity (such as raising the cap on corporate charitable contributions), the bulk of the proposals add at least some complexity to the tax system.

Some of the proposals that increase complexity do so only very modestly. For example, the business credit for combined heat and power (CHP) property would likely be easy to determine eligibility for, relatively easy to administer, and would affect few taxpayers as there are not likely to be many investors in such property. However, the credit introduces complexity for taxpayers making the determination of the precise boundaries of the property that is eligible for the credit.

Other proposals have numerous sources of complexity and affect millions of taxpayers. In particular, the proposed tax credit for the purchase of health insurance would introduce numerous complexity issues; the most significant source of complexity would be the development of systems to administer the advanced payment features of the credit. Eligibility issues would prove complex as well, because eligible health insurance would need to be defined, as well as eligible taxpayers and children. Advancing the credit complicates these eligibility issues, because it will be difficult to determine concurrent eligibility for a variety of reasons, including the difficulty of knowing in advance one's annual income, which determines both eligibility for, and the size of, the credit. This credit is also a refundable credit, meaning that the Federal government will pay the credit in amounts in excess of tax liability. Refundable credits add particular complexities to a tax system. First, the refundable feature creates situations where individuals who would otherwise not have to file a tax return are brought into the tax system in order to collect the credit. This increases burdens on the IRS, as well as on the affected individuals, by requiring the filing of more tax returns in the aggregate. Additionally, experience with the earned income credit suggests that fraud is a problem and that the IRS has difficulty collecting credits paid out in error.

The charitable contribution deduction for non-itemizers would also add complexity for millions of taxpayers. Adding the deduction for non-itemizers would require that millions more taxpayers keep records of small contributions, and would lead to more disputes with the IRS on audits. This proposal and others like it that allow additional deductions for non-itemizers (such as the present-law student loan interest deduction) threaten to undermine one of the principal purposes of the standard deduction--that of simplifying returns for those with a low level of itemizable deductions by eliminating the need for record keeping and accounting for these deductions by allowing instead the standard deduction. As the exceptions multiply, all taxpayers in effect become itemizers, which leads to more complicated tax return preparation and administration.

Finally, the proposal to allow tax-free withdrawals from Individual Retirement Accounts (IRAs) for charitable contributions adds complexity to the tax system. The proposal's objectives could be achieved, also through the tax system, in a far less complicated manner. The proposal gives IRA owners a means to avoid the percentage of income limitations for charitable contributions imposed elsewhere in the Code.[6] There seems to be no particular policy reason that IRA owners should be permitted to avoid this limitation, but not other taxpayers. Therefore, if the limitation is perceived to be a problem that limits charitable giving, it would be simpler to eliminate, or at least raise, these limitations. Thus, rather than adding a complex provision that would work at cross purposes to another complex provision, taxpayers would be better served by making the present limitation less binding. This would provide some simplification to the Code for those taxpayers who would no longer need to make the calculations to determine nondeductible contributions and no longer be subject to carryforwards of the deduction.

Overall, the President's 2003 fiscal year budget proposal would add one new personal exemption for individuals, two new exclusions from income, three new deductions for individuals that are allowed regardless of whether the taxpayer itemizes deductions, one new deduction for businesses, and eight new credits (plus the expansion in scope of an existing credit), two of which are refundable and one of which has an income-based phaseout.

The staff of the Joint Committee on Taxation has included in this analysis of the President's Fiscal Year 2003 Budget Proposals a detailed discussion of the increased complexity, or improvements in simplification, that would arise from the adoption of each of the President's proposals.

[6] The proposal also effectively provides a means for taxpayers with IRA income who take the standard deduction to get an additional deduction for charitable contributions.

II. TAX INCENTIVES

A. Provisions Related to Charitable Giving

1. Charitable contribution deduction for nonitemizers

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 170(c) of the Code, including charities and Federal, State, and local governmental entities. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[7]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[8] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[9]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to

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[7] Secs. 170(b) and (e).

[8] Sec. 170(f)(8).

[9] Sec. 6115.

public charities generally may be deducted up to 30 percent of the taxpayer's contribution base; (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base; and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes an overall limitation on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). The threshold amount is indexed for inflation. For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases-out the overall limitation on itemized deductions for all taxpayers. The 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 on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however this elimination of the limitation sunsets on December 31, 2010.

Description of Proposal

The proposal would provide a deduction from adjusted gross income for charitable contributions made by taxpayers who do not itemize deductions. This deduction would be allowed in addition to the standard deduction and generally would be subject to the tax rules normally governing charitable deductions, such as the substantiation requirements and percentage limitations. The deduction would be allowed in computing alternative minimum taxable income.

The deduction would be phased in between 2002 and 2012. The maximum deduction would be $100 ($200 in the case of a joint return) in 2002 through 2004, $300 ($600 in the case of a joint return) in 2005 through 2011, and $500 ($1000 in the case of a joint return) in 2012 and thereafter.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

The standard deduction provides a minimum exemption from income that provides relief to taxpayers who choose not to itemize but who may make charitable contributions, pay mortgage interest, or incur other expenses that otherwise are permitted as itemized deductions

under the Code. Taxpayers generally will choose to itemize deductions, rather than claim the standard deduction, if it is in their financial interest to itemize. Thus, for most taxpayers who choose the standard deduction under present law, the standard deduction more than compensates the donor for the income he or she has forgone even when they have made substantial charitable contributions.

The proposal is intended to provide an incentive for charitable giving. Proponents of the proposal would argue that taxpayers who take the standard deduction would have an incentive not present in current law to make a charitable contribution because some or all of the contribution would be deductible. Some argue, however, that the standard deduction already takes into account a taxpayer's charitable contributions and that the nonitemizer deduction would not lead to much, if any, additional giving. On the other hand, taxpayers who take the standard deduction and do not currently make charitable contributions might respond to the incentive presented by a nonitemizer charitable deduction, and begin to give to charity. In addition, some argue that the proposal would encourage taxpayers who currently take the standard deduction and make charitable contributions to increase their level of giving. At a minimum, some argue that the standard deduction does not adequately recognize a taxpayer's charitable contributions and that all taxpayers should be given a separate deduction to acknowledge their charitable giving. Others argue that the provision would be difficult to administer effectively, and therefore, could invite widespread taxpayer fraud. This could occur, for example, if taxpayers believe that IRS would not make the effort to verify small contributions.

As with any tax deduction, the charitable deduction is worth more the higher the taxpayer's marginal tax rate. Thus, higher rather than lower income taxpayers generally have a greater incentive to make charitable contributions because the price of giving is less for those with a higher income.[10] Indeed, under present law, lower income taxpayers are less likely than higher income taxpayers to itemize deductions and, in such event, have no direct tax incentive to make charitable contributions because a nonitemizing taxpayer pays the full price of the gift.[11] Thus, the proposal would provide nonitemizers with a direct tax incentive to make charitable contributions by reducing the tax price of giving. However, the proposal would cap the

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[10] The price of giving is determined as one minus the taxpayer's marginal tax rate. For example, for a taxpayer who itemizes deductions and is in the 31-percent tax bracket, a $100 cash gift to charity reduces the taxpayer's taxable income by $100, and thereby reduces tax liability by $31. As a consequence, the $100 cash gift to charity reduces the taxpayer's after-tax income by only $69. Economists would say that the price of giving $100 cash to charity is $69 for this taxpayer.

[11] A taxpayer always has a tax incentive to give to the extent that charitable contributions plus other qualifying deductions exceed the standard deduction amount. In general, however, a nonitemizing taxpayer has no tax incentive under present law to make a charitable contribution because the taxpayer will receive the standard deduction whether or not the taxpayer makes a charitable contribution. Nevertheless, some would argue that a nonitemizing taxpayer that makes a charitable contribution receives a tax benefit because the standard deduction is not intended as a windfall but as a substitute for itemization for taxpayers with comparatively low amounts of qualifying deductions.

nonitemizer deduction at an applicable amount. The tax price of giving is only reduced for contribution amounts below the cap. Nonitemizers who give greater amounts to charity do not face a reduced tax price for additional giving until it becomes advantageous for them to itemize deductions. In addition, in some cases, taxpayers could find it beneficial to reduce charitable donations.[12]

While factors other than tax benefits also motivate charitable giving, the preponderance of evidence suggests that the charitable donation tax deduction has been a stimulant to charitable giving, at least for higher-income individuals. Economic studies generally have established that charitable giving responds to the price of giving. While the economic literature suggests that individuals alter their giving in response to changes in the price of giving, there is less consensus as to how large are the changes in donations induced by the tax deductibility of charitable donations.[13] In addition, most studies rely upon data relating to taxpayers who itemize deductions. Inferences drawn from such studies may be inappropriate when applied to taxpayers who currently claim the standard deduction. Some evidence suggests that higher-income taxpayers are more responsive to the incentives provided by the tax deduction.[14]

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[12] Take, for example, a taxpayer who finds it beneficial to itemize all qualifying deductions under present law but who, under the proposal, would find it more beneficial to claim the standard deduction and additional deduction for charitable contributions (e.g., a taxpayer with more than $200 in charitable contributions and total qualifying deductions that are less than the standard deduction plus $200). In such a case, the proposal reduces the incentive to make additional charitable contributions and also could encourage a taxpayer to reduce contributions to $200 (assuming the tax incentive was a determinative factor for gifts over $200). As an itemizer, each additional dollar of charitable donation carries with it a tax benefit; however, forgoing itemization for the standard deduction results in additional dollars of charitable donation conferring no tax benefit, at least over some range of potential additional donations.

[13] See, Charles Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985, for a review of the literature. Martin Feldstein and Charles Clotfelter, "Tax Incentives and Charitable Contributions in the United States," *Journal of Public Economics*, 5, 1976, argue that the deduction for charitable contributions induces charitable contributions in amounts exceeding the revenue lost to the government from the tax deduction. More recently, William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy*, 103, August 1995, pp. 709-738, argues the opposite. Randolph argues that earlier studies inadvertently confused timing effects that may be the result of an individual taxpayer's circumstances in a particular year or the result of changes from one tax regime to another with the permanent effects. Randolph's estimates suggest that on a permanent basis, charitable donations are much less responsive to the tax price than previously believed. Charles T. Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in Joel Slemrod, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986* (Cambridge: MIT Press), 1990, p. 228, points to the surge in giving in 1986 prior to enactment of the Tax Reform Act of 1986 as evidence of the tax-sensitive timing of gifts.

[14] See, Charles Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective."

If taxpayers do respond to the proposal by making additional gifts, then the charitable sector would become larger because it would receive more donations under the proposal than it would in the absence of the preferential tax treatment provided by the proposal. Depending upon the magnitude of the additional or induced donations, the increase in the size of the charitable sector may be less than, equal to, or greater than the tax revenue forgone. If the increase in donations to the charitable sector induced by the tax deduction exceeds the revenue lost to the government, then the tax deduction could be said to be an efficient means of providing public support to such charitable functions.[15]

Opponents of proposals to expand charitable deductions argue that many charitable contributions are not tax motivated, but would be made in any event for non-tax reasons. Accordingly, for such contributions, a tax deduction amounts to a windfall reduction in the taxpayer's liability with no change in the taxpayer's behavior. Thus, critics of the proposal argue that many taxpayers who take the standard deduction already make charitable contributions and that providing an additional deduction will not induce additional giving by such individuals, but rather would reward existing levels of giving -- effectively increasing the amount of the standard deduction.

Charitable organizations often are described as providing many services at little or no direct cost to taxpayers, which services otherwise would have to be provided by the government at full cost to taxpayers. In this view, the tax deduction for voluntary charitable donations is seen as equivalent to deductions permitted for many State and local taxes. The charitable contribution tax deduction could be said to provide neutrality in the choice to provide certain services to the public through direct government operation and financing or through the private operation and mixed private and public financing of a charitable organization. In this view, opponents of the proposal would argue that an additional deduction for charitable contributions is unwarranted as the taxpayer has chosen to claim the standard deduction in lieu of claiming an itemized deduction for State and local taxes and no additional deduction is necessary to maintain neutrality of choice.

The tax deduction for charitable contributions sometimes is referred to as a tax expenditure in that it may be considered to be analogous to a direct outlay program that would direct Federal funds to charitable organizations. Applying this analogy, the tax deduction for charitable contributions is most similar to those direct spending programs that have no spending limits,[16] and that are available as entitlements to those organizations that meet the statutory

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[15] In the empirical economics literature, the notion of elasticity is used as a measure of taxpayer response to a change in the "tax price" or value of the tax deduction. An elasticity greater than one in absolute value (that is, a value smaller than negative one or a value greater than positive one) implies that recipients of charitable donations receive more increased funding than the government loses in forgone revenue. See Clotfelter, *Federal Tax Policy and Charitable Giving.*

[16] Charitable contribution deductions are subject to the applicable percentage limitation. In general, contributions in excess of the percentage limitation may be carried forward and deducted for five years.

criteria established under section 170(c). The proposal would expand the tax expenditure of present law by increasing the number of taxpayers who qualify to claim a tax deduction.

A substantial amount of charitable donations made by individuals is not claimed as itemized deductions. However, there are no data that directly measure the magnitude of charitable donations by non-itemizers. Table 1 and Table 2 below offer some indirect evidence on the magnitude of such giving. Table 1 and presents estimates of the American Association of Fund-Raising Counsel Trust for Philanthropy of the total amount of charitable donations received by qualifying organizations from individuals. By contrast, Table 2 reports itemized deductions claimed for charitable donations as reported to the Internal Revenue Service. Comparison of the two tables would suggest that in 1999, nearly $18 billion in charitable contributions made by individuals were not claimed as itemized deductions. Unfortunately, differences in the amounts reported in Table 1 and Table 2 cannot be interpreted as measures of amounts of contributions made by non-itemizers. Evidence from audits and in taxpayer compliance studies establishes that many taxpayers overstate their actual donations when claiming itemized deductions.[17] These findings suggest that if one were to use the difference in the amounts reported in and Table 2 to estimate the magnitude of charitable donations by non-itemizes that the result would be to under-estimate actual donations by non-itemizers.[18] Moreover, experience among taxpayers who itemize suggests that, if non-itemizers were allowed to claim a deduction for their charitable donations, many non-itemizers likely would overstate their actual donations for the purpose of claiming a tax benefit.

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[17] Joel Slemrod, "Are Estimated Tax Elasticities Really Just Tax Evasion Elasticities? The Case of Charitable Contributions," *The Review of Economics and Statistics,* vol. 71, (August 1989), pp. 517-522. Slemrod examined data from the IRS's Taxpayer Compliance Measurement Program. In this sample, more than one quarter of the taxpayers who itemized deductions for charitable contributions were found, on audit, to have overstated their charitable contributions. (Some taxpayers also were found to have understated their charitable contributions.) The evidence on overstatement of actual contributions may call into question the estimates cited previously of the extent to which the charitable deduction encourages taxpayers to donate to charities. Slemrod's study found that, while in theory estimated behavioral responses may be biased upwards by taxpayers overstating their contributions, the data he examined showed no material mismeasurement of the extent to which the charitable deduction encourages taxpayers to make actual contributions.

[18] Such a conclusion assumes that the figures reported in Table 1 are accurate estimates of total giving by individuals. Errors in these estimates of total donations could raise or lower estimates of donations by non-itemizers.

Table 1--Total Individual Charitable Donations Estimated to Have Been Received By Charitable Organizations, 1984-1999 (Billions of Dollars)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total individual donations	56.46	57.39	67.09	64.53	69.98	79.45	81.04	84.27	87.70	92.00	92.52	95.36	107.65	122.95	134.08	143.71

Source: *Giving USA* 2000. Data do not include donations from trusts. Tabulations prepared by the staff of the Joint Committee on Taxation.

Table 2--Individual Itemized Charitable Donations Claimed on Tax Returns, 1984-1999 (Billions of Dollars)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Deductions claimed for charitable donations	42.12	47.96	53.82	49.62	50.95	55.46	57.24	60.58	63.84	68.35	70.54	74.99	86.16	95.82	109.24	125.80

Source: Individual itemized deductions taken from Internal Revenue Service Statistics of Income data. Total individual donations taken from *Giving USA*, 2000. Data do not include donations from trusts. Tabulations prepared by the staff of the Joint Committee on Taxation.

Complexity issues

The proposal adds complexity to the tax law. The proposal would affect over 50 million individual tax returns. Taxpayers who take the standard deduction and make charitable contributions would have to keep additional records (e.g., canceled checks, a receipt from the donee organization, or other reliable written records) in order to substantiate that a contribution was made to a qualified charitable organization. In addition, the proposal, like any other "non-itemizer" deduction, would undermine the purpose of the standard deduction, which exists in part to relieve taxpayers with small deductions from the burdens of itemization and substantiation. One motivation behind the substantial increase in the standard deduction in the Tax Reform Act of 1986 was that "[t]axpayers who will use the standard deduction rather than itemize their deductions will be freed from much of the record keeping, paperwork, and computations that were required under prior law."[19] On the other hand, the proposal could simplify the law for a limited number of taxpayers who currently itemize but would choose to claim the standard deduction under the proposal. Taxpayers who currently itemize, but have total itemized deductions that exceed the standard deduction by less than $200 (in the case of a joint return in 2002 through 2004, greater amounts in later years as described above) would receive more tax benefit if they claimed the standard deduction, provided they have charitable contributions at least equal to the amount by which their total deductions exceed the standard deduction. By switching to the standard deduction, such taxpayers would no longer have to itemize deductions (other than the nonitemizer charitable deduction). However, any potential itemizers who choose to take the standard deduction as a result of these calculations would still

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[19] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, 11.

need to keep records of potential itemized deductions in order to make the calculation, and thus simplification benefits are diminished.

The proposal would require two additional lines on the individual income tax return forms and modification to the form instructions. The proposal might result in an increase in disputes with the IRS for taxpayers who are unable to substantiate a claimed deduction. Additional regulatory guidance would not be necessary to implement the proposal.

Prior Action

The President's fiscal year 2002 budget proposal contained a similar provision. It provided a charitable nonitemizer deduction for a percentage (reaching 100 percent, when fully phased in) of a taxpayer's charitable contributions up to the amount of the taxpayer's standard deduction.

The President's fiscal year 2001 budget proposal also contained a similar provision. It provided a charitable nonitemizer deduction for 50 percent of a taxpayer's charitable contributions in excess of $1,000 ($2,000 for joint returns) through 2005 and in excess of $500 ($1,000 for joint returns) thereafter.

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, included a charitable nonitemizer deduction that provides a deduction of the lesser of (1) the amount allowable to itemizers as a charitable deduction for cash contributions and (2) an applicable amount. The applicable amount is $25 ($50 in the case of a joint return) in 2002 and 2003, $50 ($100 in the case of a joint return) in 2004 through 2006, $75 ($150 in the case of a joint return) in 2007 through 2009, and $100 ($200 in the case of a joint return) in 2010 and thereafter.[20]

2. Tax-free withdrawals from individual retirement arrangements for charitable contributions

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply, and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

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[20] The Economic Recovery Tax Act of 1981 added to the law a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

Charitable contributions

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 170(c), including charities and Federal, State, and local governmental entities. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[21]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[22] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[23]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base; (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base; and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

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[21] Secs. 170(b) and (e).

[22] Sec. 170(f)(8).

[23] Sec. 6115.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes an overall limitation on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases out the overall limitation on itemized deductions for all taxpayers. The 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 on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[24] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[25] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are

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[24] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[25] Sec. 170(f)(2).

treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[26] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Traditional IRAs are subject to minimum distribution rules that require that distributions from the IRA begin no later than the required beginning date. Traditional and Roth IRAs are subject to post-death minimum distribution rules that require that distributions of the death of the IRA owner must begin by a certain time.

Description of Proposal

The proposal would provide an exclusion from gross income for otherwise taxable IRA withdrawals from a traditional or a Roth IRA for distributions to a qualified charitable organization. The exclusion would not apply to indirect gifts to a charity through a split interest entity, such as a charitable remainder trust, a pooled income fund, or a charitable gift annuity. The exclusion would be available for distributions made on or after the date the IRA owner attains age 59-1/2 and would apply only to the extent the individual does not receive any benefit in exchange for the transfer. Amounts transferred directly from the IRA to the qualified charitable organization would be treated as a distribution for purposes of the minimum distribution rules applicable to IRAs. Amounts transferred from the IRA to the qualified organization that would not be taxable if transferred directly to the individual, such as a qualified distribution from a Roth IRA or the return of nondeductible contributions from a traditional IRA, would be subject to the normal charitable contribution deduction rules.

Effective date.--The proposal would be effective for distributions after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

In general, the proposal is intended to enable IRA owners to give a portion of their IRA assets to charity without being subject to the charitable contribution percentage limitations or the overall limitation on itemized deductions. Present law requires an IRA owner to take the IRA distribution into income, give the money to a qualified charity, and then claim a deduction for the gift. However, the deduction is subject to the percentage limitations of section 170 and to the

[26] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

overall limit on itemized deductions. The proposal would avoid these limitations and therefore might encourage additional charitable giving by increasing the tax benefit of the donation among those who would not be able to fully deduct the donation by reason of the present-law limitations. However, some argue that the proposal merely avoids present-law limitations on charitable contributions that would be made in any event and would not encourage additional giving. In addition, some argue that the proposal inappropriately would encourage IRA owners to use retirement monies for nonretirement purposes (by making such use easier and providing greater tax benefits in some cases). To the extent that the proposal would spur additional gifts by circumventing the percentage limitations, IRA owners may spend more of their retirement money for nonretirement purposes than under present law.

Further, some question the appropriateness of limiting the tax benefits of the provision to IRA owners. That is, if the limits on charitable deductions are determined to be undesirable, they should be removed for all taxpayers, not only those that are able to make charitable contributions through an IRA. In addition, the proposal would alter present law and give IRA owners a tax benefit for charitable contributions even if they do not itemize deductions. For example, under present law, a taxpayer who takes the standard deduction cannot claim a charitable contribution deduction; however, under the proposal, a taxpayer could both claim the standard deduction and benefit from the exclusion. It might be beneficial for taxpayers who itemize their deductions but have a significant amount of charitable deductions to make their charitable contributions through the IRA and then claim the standard deduction.

Complexity issues

The proposal would add complexity to the tax law by creating an additional set of rules applicable to charitable donations. Taxpayers who own IRAs and make such donations would need to review two sets of rules in order to determine which applies to them and which is the most advantageous. The proposal may increase the complexity of making charitable contributions because individuals who are able and wish to take advantage of the tax benefits provided by the proposal will need to make the donation through the IRA rather than directly. The proposal also may increase complexity in tax planning as the proposal might make it beneficial for some taxpayers to take the standard deduction and make all charitable contributions through their IRAs.

In some cases, taxpayers may need to apply both sets of rules to a single contribution from an IRA. This would occur if the IRA distribution includes both taxable amounts (which would be subject to the rules in the proposal) and nontaxable amounts (which would be subject to the present-law rules). As discussed above, the effect of the proposal is to eliminate certain present-law limits on charitable deductions for IRA owners. A simpler approach would be to eliminate such limits with respect to all charitable contributions. Providing a single rule for charitable contributions would make the charitable deduction rules easier to understand for all taxpayers making such contributions.

Prior Action

The President's fiscal year 2002 budget proposals included this proposal.

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes a similar provision, except the H.R. 7 provision applies to distributions only once the IRA owner reaches age 70-1/2. H.R. 7 also provides for a similar exclusion for transfers to split interest entities, including charitable remainder trusts, pooled income funds, and charitable gift annuities.

3. Raise the cap on corporate charitable contributions

Present Law

Under present law, a corporation is allowed to deduct charitable contributions of up to 10 percent of the corporation's taxable income for the year. For this purpose, taxable income is determined without regard to (1) the charitable contributions deduction; (2) any net operating loss carryback; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback for the taxable year.[27] Any charitable contribution by a corporation that is not currently deductible because of the percentage limitation may be carried forward for up to five taxable years.

A transfer of property by a business to a charity might qualify as either a charitable contribution or a deductible business expense, but not both. No deduction is allowed as a business expense under section 162 for any contribution that would be deductible as a charitable gift were it not for the percentage limitations on the charitable contributions deduction.[28] Likewise, a business transfer made with a reasonable expectation of financial return commensurate with the amount of the transfer is not deductible as a charitable contribution, but may be deductible under section 162.

Description of Proposal

The proposal would increase the percentage limitation on corporate charitable deductions from 10 percent to 15 percent.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

In general, the proposal is intended to encourage corporations to make additional gifts to charity. Under the proposal, corporations that now limit their charitable giving at the present-law cap would have an incentive to give more, at least up to the proposed cap. However, some argue that corporations that make charitable contributions are not motivated by the promise of a charitable deduction but rather make such contributions primarily because corporate

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[27] Sec. 170(b)(2).

[28] Sec. 162(b).

philanthropy advances corporate and shareholder interests. Thus, some would argue that increasing the cap on corporate charitable contributions will not be a significant factor for a corporation determining whether to make a charitable contribution.

Complexity issues

The proposal would not add complexity to the tax law because it merely substitutes one number (15 percent) for another number (10 percent). Corporations giving more than 10 percent of modified taxable income for a year would have to keep records to substantiate the gifts; however, corporations already are required to maintain such records so the proposal would not introduce a new recordkeeping requirement.

Prior Action

The President's fiscal year 2002 budget proposals included this proposal.

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes a similar provision. H.R. 7 phases in an increase to the cap on corporate charitable contributions over nine years, as follows: 11 percent in 2002 through 2007, 12 percent in 2008, 13 percent in 2009, and 15 percent in 2010 and thereafter.

4. Enhanced charitable deduction for contributions of food inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) the taxpayer's basis in the contributed property plus one-half of the property's appreciated value (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[29]

To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c) (other than a private nonoperating foundation), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To claim the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value

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[29] Sec. 170(e)(3).

of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[30]

Description of Proposal

Under the proposal, the enhanced deduction for donations of food inventory would be increased to the lesser of (1) fair market value, or (2) two times the taxpayer's basis in the contributed inventory. In addition, any taxpayer engaged in a trade or business, whether or not a C corporation, would be eligible to claim an enhanced deduction for donations of food inventory. The deduction for donations by S corporations and noncorporate taxpayers would be limited to 15 percent of the net income from the trade or business. The proposal would provide a special rule that would allow certain taxpayers with a zero or low basis in the food donation (e.g., taxpayers that use the cash method of accounting for purchases and sales, and taxpayers that are not required to capitalize indirect costs) to assume a basis equal to 25 percent of the food's fair market value. In such cases, the allowable charitable deduction would equal 50 percent of the food's fair market value. The enhanced deduction for food inventory would be available only for food that qualifies as "apparently wholesome food" (defined as food that is intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions). The proposal would provide that the fair market value of apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market would be determined by taking into account the price at which the same or substantially the same food items are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

In general, the proposal is intended to give businesses greater incentive to contribute food to those in need. By increasing the value of the enhanced deduction, up to the fair market value of the food, and by clarifying the definition of fair market value, the proposal is intended to have this result. However, some argue that if the intended policy is to support food programs for the needy, it would be more direct and efficient to provide a direct government subsidy instead of making a tax expenditure through the tax system, which may result in abuse and cannot be monitored under the annual budgetary process. On the other hand, proponents of the proposal likely would argue that a government program would be less effective in identifying the needy and overseeing delivery of the food than would the proposal.[31]

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[30] *Lucky Stores Inc. v. Commissioner,* 105 T.C. 420 (1995).

[31] See generally Louis Alan Talley, "Charitable Contributions of Food Inventory: Proposals for Change Under the "Community Solutions Act of 2001," Congressional Research Service Report for Congress (August 23, 2001).

More specifically, critics argue that the definition of fair market value under the proposal is too generous because it may permit taxpayers to claim as fair market value the full retail price of food that was no longer fresh when donated. If so, taxpayers might be better off contributing the food to charity than by selling the food in the ordinary course of their business. In addition, to the extent the proposal would subsidize food disposal, companies producing food may take less care in managing their inventories and might have less incentive to sell aging food by lowering prices, knowing that doing so might also reduce the value of an eventual deduction.[32] Critics also argue that the proposal would in effect provide a deduction for the value of services, which are not otherwise deductible, because in some cases, services are built into the fair market value of food.

Complexity issues

The proposal has elements that may both add to and reduce complexity of the charitable contribution deduction rules. Under present law, the general rule is that charitable gifts of inventory provide the donor with a deduction in the amount of the donor's basis in the inventory. The Code currently contains several exceptions: a special rule for contributions of inventory that is used by the donee solely for the care of the ill, the needy, or infants, a special rule for contributions of scientific property used for research, and a special rule for contributions of computer technology and equipment used for educational purposes. Each special rule has distinct requirements. The proposal would add another special rule, with its own distinct requirements, thereby increasing the complexity of an already complex section of the Code. The proposal also could decrease complexity because it would provide a definition of fair market value. Under current law, valuation of food inventory has been a disputed issue between taxpayers and the IRS and a cause of uncertainty for taxpayers when claiming the deduction. However, the proposal's definition of fair market value also may invite interpretive questions. For example, it is not clear from the definition whether the price at which the food was sold at the time of the contribution is to be the exclusive factor determining fair market value, or if not the exclusive factor, how much weight should be given to other factors, such as the freshness of the food. Another interpretative issue could arise in deciding whether the contributed food is "substantially" the same as other food items sold by the taxpayer for purposes of determining fair market value of the food.

Prior Action

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes a similar provision, except that H.R. 7 does not increase the value of the enhanced deduction, does not introduce a separate percentage limit on the deduction for non C corporations, and does not provide for a special basis rule for taxpayer's with zero or low basis in the contributed food inventory.

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[32] See Martin A. Sullivan, "Economic Analysis: Can Bush Fight Hunger With a Tax Break?," 94 *Tax Notes* 671 (Feb. 11, 2002).

5. Reform excise tax based on investment income of private foundations

Present Law

In general, a private foundation is an organization organized and operated exclusively for charitable purposes. Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts, also are subject to an excise tax, under section 4940(b).

Net investment income generally includes interest, dividends, rents, royalties, and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[33] equals or exceeds the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[34] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements.[35]

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code. Exempt operating foundations are exempt from the section 4940 tax.[36]

Nonoperating private foundations are required to make a minimum amount of charitable distributions ("qualifying distributions") each year to avoid tax under section 4942. If a nonoperating private foundation makes qualifying distributions equal to the "distributable amount," then no tax is owed under section 4942. The distributable amount generally is five

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[33] Sec. 4942(g).

[34] Sec. 4940(e).

[35] Sec. 4942.

[36] Sec. 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must (1) be an operating foundation (as defined in section 4942(j)(3)), (2) be publicly supported for at least 10 taxable years, (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public, and (4) have no officers who are disqualified persons. Sec. 4940(d)(2).

percent of the fair market value of the foundation's noncharitable use assets less the amount of taxes paid, including taxes under section 4940.[37] Thus, the minimum amount of qualifying distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.

Description of Proposal

The proposal would replace the two rates of tax under present law with a single rate of tax based on net investment income and would set such rate of tax at one percent. A tax-exempt private foundation would be subject to tax on one percent of net investment income. A taxable private foundation would be subject to tax on the excess of the sum of the one percent excise tax and the amount of the unrelated business income tax (both calculated as if the foundation were tax-exempt) over the income tax imposed on the foundation. The proposal would repeal the special one-percent excise tax for private foundations that exceed their historical level of qualifying distributions.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

The proposal would increase the required minimum charitable payout for nonoperating private foundations that pay the excise tax at the two-percent rate, which may result in an increase in charitable distributions.[38] Under present law, the amount that a nonoperating foundation must distribute annually for charitable purposes is reduced by the amount of excise tax paid by the foundation on its net investment income. For example, if a foundation is subject to the two-percent excise tax on net investment income, the foundation reduces the amount of required charitable distributions by the amount of excise tax paid. Because the proposal would decrease the amount of excise tax paid on net investment income for such foundations, the proposal would increase such foundations' required minimum amount of charitable distributions by one percent. Thus, the proposal would result in an increase of charitable distributions in the case of foundations paying the two-percent rate and distributing no greater than the required minimum under present law. Foundations paying the two-percent rate that exceed the required minimum under present law generally would not have to increase their charitable distributions as a result of the proposal. Although the required minimum amount of charitable distributions would increase for such foundations, such foundations already make distributions exceeding the minimum and so generally would not have to increase charitable distributions as a result of the proposal (except to the extent that the increase in the required minimum amount was greater than the excess of a private foundation's charitable distributions over the required minimum amount of present law).

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[37] Secs. 4942(d)(2) and (e).

[38] Operating foundations are not subject to the minimum charitable payout rules. Sec. 4942(a)(1).

The proposal also would eliminate the present-law two-tier tax structure. Some have suggested that the two-tier excise tax may serve as an incentive for foundations to increase the amounts they distribute to charities.[39] Critics of the present-law two-tier excise tax have criticized the efficiency of the excise tax as an incentive to increase payout rates. First, critics note, the reduction in excise tax depends only upon an increase in the foundation's rate of distributions to charities, not on the size of the increase in the rate of distributions. Thus, a large increase in distributions is rewarded by the same reduction in excise tax rate as is a small increase in distributions. There is no extra incentive to make a substantial increase in distributions rather than a quite modest increase in distributions.

In addition, critics assert that, under a number of circumstances, the present-law two-tier excise tax can create a disincentive for foundations to increase charitable distributions substantially.[40] In order to take advantage of the one-percent excise tax rate, a private foundation must increase its rate of charitable distributions in the current year above that which prevailed in the preceding five years. Whether the present-law two-tier excise tax creates an incentive or disincentive to increased payout rates depends, in part, on whether the foundation currently is subject to the one-percent tax rate or the two-percent tax rate. Because modest increases in payout rates qualify a foundation for the one-percent tax rate, some analysts suggest that a foundation may be able to actively manage its distributions so that the foundation qualifies for the one-percent tax rate without substantially increasing its payout rate.[41] For a foundation subject to the one-percent rate in the current year, an increased payout in any year becomes part of the computation to determine eligibility for the one-percent rate in future years. Thus, under the present-law formula, the foundation can trigger the two-percent excise tax rate by increasing the payout amount in a particular year because increased payouts make it more difficult for the foundation to qualify for the one-percent rate in subsequent years, and it increases the possibility that the foundation will become subject to the two-percent tax rate. Consequently, over time, the one-percent rate provides a disincentive for increasing charitable distributions.

On the other hand, for a foundation currently subject to the one-percent excise tax rate and also making charitable distributions at a rate above the minimum required amount, the present-law two-tier excise tax can create a disincentive for foundations to reduce their payout rate. A reduction in payout rate in the future would reduce the foundation's five-year moving

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[39] In general, foundations that make only the minimum amount of charitable distributions and seek to minimize total payouts have no incentive to decrease their rate of excise tax because such a decrease would result in an increase in the required minimum amount of charitable distributions, thus making no difference to the total payout of the private foundation.

[40] See C. Eugene Steuerle and Martin A. Sullivan, "Toward more Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," *American Journal of Tax Policy*, 12, Fall 1995, 399-447.

[41] For example, if over a ten-year period the foundation increased its payout rate from the minimum 5.00 percent to 5.01 percent, to 5.02 percent, up to 5.10 percent, the foundation generally would qualify for the one-percent excise tax rate throughout the ten-year period.

average, thereby increasing the likelihood the foundation's net investment income is taxed at the two-percent rate, rather than the one-percent rate.[42]

For a foundation currently subject to the excise tax at the two-percent rate, an increase in payout may qualify the foundation for the one-percent excise tax rate. If the increase does qualify the foundation for the one-percent rate, and the foundation maintains the same payout for the subsequent four years, the foundation generally will be eligible for the one-percent tax rate in each of the five years. Hence the reduced tax rate can create an incentive to increase payout rates. However, even in the case of a two-percent excise tax paying foundation, the present-law two-tier excise tax can create a disincentive for a foundation to increase charitable distributions substantially in any one year compared to a strategy of slowly increasing payouts over several years. For example, consider a foundation which has had a payout rate of 5.0 percent for several years. Suppose the foundation is considering increasing its payout rate. Consider two possible strategies: increase the payout rate to 8.0 percent in the current year followed by rates of 5.5 percent thereafter; or gradually increase the payout rate by increments of one-tenth of one percent annually for five years. While a substantial increase in any one year may qualify the foundation for the one-percent tax rate, subsequent year payout rates of 5.5 percent would fail to qualify the foundation for the one- percent tax rate.[43] Thus, under the first option, the foundation would pay the one-percent tax rate for one year and be a two-percent tax rate payor subsequently. Under the second option, the foundation would qualify for the one-percent rate in each year. However, total payouts are greater under the first option.

In summary, the incentive effects of the present-law two-tier excise tax depend upon the situation in which the foundation finds itself in the current year. In 1995, 36 percent of foundations were one-percent tax rate payors and 64 percent were two-percent rate payors. Among large foundations (assets of $ 50 million or greater) 47 percent were one-percent rate payors and 51 percent were two-percent rate payors.[44] A number of analysts suggest the optimal tax strategy for a private foundation is to choose a target rate of disbursement, maintain that rate in all years, and never fall below the target in any year.[45]

Critics of the present-law excise tax structure observe that the median payout rate of large nonoperating private foundations (foundations with total assets of $50 million or more) was 5.1 or 5.0 percent in each year from 1991 through 1995. The median payout rates for foundations

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[42] Whether a reduction in payout rate causes the foundation to pay the two-percent tax rate depends upon the specific pattern of its payout rate in the preceding five years and the magnitude of the decrease in the current year.

[43] In this example, after having paid out 8.0 percent, the five-year average payout for the first year in which the foundation pays out 5.5 percent would be 5.6 percent.

[44] See Figure E in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999, 60-125.

[45] Steuerle and Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," 438.

with assets between $10 million and $50 million declined annually from 5.4 percent in 1990 to 5.1 percent in 1995. Similarly, the median payout rates for foundations with assets between $100,000 and $1 million declined from 6.7 percent in 1990 to 5.5 percent in 1995.[46] Critics of the present-law excise tax structure argue that these data suggest that the excise tax structure is not encouraging any noticeable increase in payout rates.

Complexity issues

The proposal would reduce complexity for private foundations by replacing the two-tier tax on net investment income with a one-tier tax. Under the proposal, private foundations would not have to allocate resources to figuring which tier of the tax would be applicable or to planning the optimum payout rate. The proposal also would make compliance easier for private foundations, as they would not have to compute a five-year average of charitable distributions on the information return they file each year.

Prior Action

The President's fiscal year 2001 budget proposal included a similar proposal, but would have reduced the rate of tax to 1.25 percent. H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes this provision.

6. Modify tax on unrelated business taxable income of charitable remainder trusts

Present Law

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[47]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred;

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[46] Arnsberger, "Private Foundations and Charitable Trusts, 1995," Figure I, 73.

[47] Sec. 664(d).

(2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and (4) corpus.[48]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[49]

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year.

Description of Proposal

The proposal would impose a 100 percent excise tax on the unrelated business taxable income of a charitable remainder trust. This would replace the present-law rule removing the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Under the proposal, the tax would be treated as paid from corpus. The unrelated business taxable income would be considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001, regardless of when the trust was created.

Analysis of Complexity and Policy Issues

Policy issues

The proposal is intended to be a more effective deterrent than present law to prevent charitable remainder trusts from investing in assets that generate large amounts of unrelated business taxable income. Under present law, a charitable remainder trust may invest in assets that produce significant unrelated business income but may pay tax only on the trust's undistributed income because the trust, as a taxable trust, may take a deduction for distributions of income that are taxable to the beneficiaries. To the extent the trust pays tax, trust assets are depleted to the detriment of the charitable beneficiary. Proponents argue that the proposal would deter trusts from making investments that generate significant unrelated business taxable income because the 100 percent excise tax would be prohibitive. On the other hand, for charitable

[48] Sec. 664(b).

[49] Treas. Reg. sec. 1.664-1(d)(4).

remainder trusts that make investments in assets the income from which is unrelated business taxable income, the proposal could cause those trusts to make investments that they deem less desirable, which also could diminish the value of the remainder interest.

The proposal also is intended to produce a better result than present law for trusts that have only small or inadvertent amounts of unrelated business taxable income. The present-law rule that any amount of unrelated business taxable income results in loss of tax-exemption for the year discourages trusts from making investments that might generate insignificant (or inadvertent) unrelated business taxable income. A loss of exemption could be particularly punitive in a year in which a trust sells, for example, the assets that originally funded the trust and does not distribute the proceeds. The proposal would require a trust to pay the amount of the unrelated business taxable income as an excise tax but would not require the trust to pay tax on all of its other income for the year. In addition, the proposal would be helpful to trusts that receive unrelated business taxable income as a result of a change in the status of the entity in which trust assets are invested. However, the proposal likely would enable charitable remainder trusts to make investments that some argue are and should be discouraged by present law. For example, investments in rental property may generate a small amount of unrelated business taxable income from fees for services provided to tenants. Such investments are unattractive for charitable remainder trusts under present law because the unrelated income would cause the trust to lose exemption. Under the proposal, however, a rental property owner might have an incentive to contribute the rental property to a charitable remainder trust (of which the owner was beneficiary) to shelter the rental income from tax (to the extent the rental income exceeds the unitrust amount or annuity payment). Some argue that charitable remainder trusts should not be encouraged to make such investments.

The proposal would provide that unrelated business income would be treated as ordinary income to the trust and taxes would be paid from corpus. Thus, the proposal would treat the trust beneficiary the same as under present law, that is, distributions of the unrelated business income would be taxed as ordinary income to the beneficiary. However, the proposed rule in effect taxes the unrelated business income twice, once as an excise tax (at a 100-percent rate), and again when distributed. (Double taxation presently exists to the extent that the trust's income from all sources exceeds the amount distributed to the beneficiary during a year in which the trust is not exempt from income tax.) An alternative rule could tax the unrelated business income as an excise tax but not again when distributed. Such a rule could provide that the trust would not take unrelated business income into account with the result that distributions for a taxable year that otherwise would be taxed as ordinary income to the beneficiary could be taxed as capital gain or tax-free return of corpus. Although the beneficiary would be better off than under the proposal, the unrelated income would be taxed only once. Proponents of the proposal argue, however, that because a beneficiary could be better off under the alternative rule, such a rule would not provide an effective enough deterrent to investing in unrelated business income producing assets.

Complexity issues

The proposal would simplify the operation of the charitable trust provisions in that a trust with a small amount of unrelated business taxable income would not lose its tax exemption and therefore would not need to file income tax returns and compute its taxable income as if it were a

taxable trust. This would have the effect of not discouraging trustees to make investments that might entail having a small amount of unrelated business taxable income.

Prior Action

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes a similar provision, except that unrelated business income would be excluded from the determination of (1) the value of a charitable remainder unitrust's assets, (2) the amount of charitable remainder unitrust income for purposes of determining the unitrust's required distributions, and (3) the effect on the income character of any distributions to beneficiaries by a charitable remainder annuity trust or charitable remainder unitrust.

7. Basis adjustment to stock of S corporation contributing appreciated property

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[50] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[51] As a result of the reduction of the stock basis by the value of the contributed property, the shareholder may lose the benefit of the charitable contribution deduction for the amount of any appreciation in the asset contributed.

Description of Proposal

The proposal would allow a shareholder in an S corporation to increase the basis of the S corporation stock by an amount equal to the excess of the charitable contribution deduction that flows through to the shareholder over the shareholder's pro rata share of the adjusted basis of the property contributed.[52]

Effective date.--The proposal would apply to taxable years beginning after December 31, 2001.

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[50] Sec. 1366(a)(1)(A).

[51] Sec. 1367(a)(2)(B).

[52] See Rev. Rul. 96-11 (1996-1 C.B. 140) for a similar rule applicable to contributions made by a partnership.

Analysis of Complexity and Policy Issues

Policy issues

The proposal would preserve the benefit of providing a charitable contribution deduction for contributions of property by an S corporation with a fair market value in excess of its adjusted basis by limiting the reduction in the shareholder's basis in S corporation stock to the proportionate share of the adjusted basis of the contributed property. Under the proposal, the treatment of contributions of appreciated property made by an S corporation would be similar to the treatment of contributions made by a partnership.

Complexity issues

The net reduction in basis of stock by the amount of the adjusted basis of contributed property rather than the fair market value would have little effect on tax law complexity.

Prior Action

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes this provision.

8. Expedited consideration of applications for exempt status

Present Law

Most organizations that seek tax-exempt status as a charitable organization are required to file an Application for Recognition of Exemption (Form 1023) with the IRS.[53] Organizations that are not required to file Form 1023 include churches, their integrated auxiliaries, and conventions or associations of churches, and any organization (other than a private foundation) that normally has gross receipts of $5,000 or less in a taxable year. Organizations that file Form 1023 within 15 months of the end of the month of the organization's formation will, if the application is approved, be recognized as tax-exempt from the date of formation. The IRS will automatically grant an organization's request for an additional 12-month extension of the 15-month period. Otherwise, exemption normally will be recognized as of the date the application was received by the IRS. In appropriate circumstances, upon written request, the IRS will expedite consideration of applications for tax-exemption. For example, organizations formed to provide relief to victims of disasters or other emergencies often receive expedited consideration.

Description of Proposal

The proposal would allow expedited consideration of applications for exempt status by organizations formed for the primary purpose of providing social services to the poor and the needy. To be eligible, the organization must have applied for a grant under a Federal, State, or local program that provides funding for social service programs on or before the day the organization files its tax-exemption application. If the organization establishes that tax-exempt

[53] Sec. 508(a).

status as a charity is a prerequisite to applying for such a grant and includes a completed copy of the grant application with its application for tax-exemption, then the IRS would be required to grant expedited consideration.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

Under present law, organizations that provide relief in emergency situations, such as a natural disaster, may receive expedited consideration of an application for tax-exempt status. This exception to the normal rules is justified by the nature of an emergency. If tax-exempt status is not quickly forthcoming to an organization trying to provide disaster relief, the organization may have greater difficulty raising funds (because many donors are reluctant to give money until they are assured of the deductibility of the contribution) and therefore be less effective in providing help to those with immediate needs. The proposal would permit expedited consideration of applications for tax-exemption for certain organizations in nonemergency situations, which would elevate such organizations over others in the application process. Some argue that favoring organizations that provide social services to the poor and needy, but not groups that further other exempt purposes, is simply unfair. The fact that the proposal would benefit only those organizations that have applied for a grant (or could not apply for a grant prior to gaining tax-exemption) would not lessen unfairness because, as a practical matter, grant approval contingent on exempt status is not unique to organizations that serve the poor and the needy but affects many other organizations. Proponents of the proposal would argue that expedited consideration for groups providing social services to the poor and needy is justified because, for example, the poor have a more urgent need for help than other recipients of aid.

In addition, to the extent the proposal shortens the exemption application process for some organizations, it generally would lengthen the process for all other organizations unless additional personnel are used to handle expedited applications.

Complexity issues

In general, the proposal would not complicate the tax-exemption application process for the applicants. The standards for exemption would remain the same whether or not an organization would benefit from the proposal. Although an organization would have to demonstrate its eligibility for expedited consideration, such a showing would not require the organization to prepare much if any additional paperwork.

The proposal could introduce administrative complexity in that the IRS would be faced with an increase in the number of applications that merit expedited consideration. If the increase was significant, additional personnel might be needed to process the applications quickly and the IRS would have to prioritize applications based on the nature of the organization -- i.e., organizations that provide emergency relief arguably should be considered before other organizations receiving expedited consideration.

Prior Action

No prior action.

B. Education Provisions

1. Refundable tax credit for certain costs of attending a different school for pupils assigned to failing public schools

Present Law

P.L. 107-110, the "No Child Left Behind Act of 2001" amended the Elementary and Secondary Education Act of 1965 to provide that Federal grant funds may be used by local educational agencies to provide supplemental educational services, such as tutoring and summer school, to children enrolled in a public school "identified for school improvement" for two consecutive years. A school is identified for improvement after failing to make "adequate yearly progress" for two consecutive years under standards established by State law. If a school is identified for improvement, local educational agencies must (unless prohibited by State law) provide students enrolled at such a school the option to transfer to another public school within the jurisdiction of the local educational agency, including a public charter school. The local educational agency is required to provide transportation to students who request such a transfer. A student who transfers is permitted to remain at the new school through such school's highest grade; however, the local educational agency is not required to provide transportation if the student's original school has improved to make adequate yearly progress. Federal funds generally may not be used to pay the costs of attending a private school.

Section 530 of the Code provides tax-exempt status to Coverdell education savings accounts, meaning certain trusts or custodial accounts that are created or organized in the United States exclusively for the purpose of paying the "qualified education expenses" of a designated beneficiary. Contributions to Coverdell education savings accounts may be made only in cash. Annual contributions to Coverdell education savings accounts may not exceed $2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn. However, distributions from a Coverdell education savings account are excludable from the gross income of the beneficiary to the extent that the total distribution does not exceed the qualified higher education expenses incurred by the beneficiary during the year the distribution is made.

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from a Coverdell education savings account, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income. The earnings portion of a distribution from a Coverdell education savings account that is includible in income also generally is subject to an additional ten percent tax.

Qualified education expenses include both expenses for higher education and for elementary and secondary school. Qualified elementary and secondary school expenses include expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law, (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary, and (3) the purchase of computer technology or equipment or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is educational in nature.

Description of Proposal

The proposal would provide a refundable tax credit for expenses incurred in connection with a student's transfer from a failing public school to a different public school in another jurisdiction or to a private school. Specifically, the proposal would credit 50 percent of the first $5,000 of a taxpayer's qualifying educational expenses incurred with respect to a qualifying child's attendance at a qualifying school as a qualifying student. The credit would be allowable for more than one qualifying child and would apply against both regular and alternative minimum tax. Taxpayers claiming the credit would be required to provide the name and taxpayer identification number of the qualifying student and the name and address of the local school that the student normally would have attended. In addition, taxpayers would be required to substantiate qualifying expenses.

Qualifying expenses would be tuition and required fees, transportation expenses, and certain other expenses, including expenditures for academic tutoring, special needs services in the case of a special needs student, books, supplies, computer technology and equipment, room and board, uniforms, and supplementary items and services (including extended day care programs) that are required or provided by the school. Tuition or required fees paid to a public school within the jurisdiction of the local education agency would not qualify. Qualified elementary and secondary education expenses for purposes of Coverdell education savings accounts also would qualify, but the taxpayer could not claim the credit and treat the expenses for which the credit was claimed as qualifying distributions from the Coverdell account. In the case of a qualified school that is a home school (as defined by State law), qualifying expenses would include expenditures for academic tutoring, special needs services in the case of a special needs student, books, supplies, and computer technology and equipment. In general, a credit would be allowed only for payments of qualified expenses for an academic period beginning in the same taxable year as the year the payment is made.[54]

[54] Qualifying payments would follow the timing rules used in connection with the Hope and Lifetime Learning credits. See Prop. Treas. Reg. sec. 1.25A-5(e).

A qualifying child would be a child who has the same principal place of abode as the taxpayer for more than one-half of the taxable year and is the taxpayer's son, daughter, stepson or stepdaughter, or a sibling or stepsibling of the taxpayer (or descendant of a sibling or stepsibling of the taxpayer) who the taxpayer cares for as the taxpayer's own child. An eligible foster child within the meaning of the earned income tax credit also would qualify.

A qualifying student generally would be a student in grades K through 12 who, according to school attendance rules and local educational agency boundaries, attended at the close of the prior school year a public elementary or secondary school ("the local school") identified as failing to make adequate yearly progress. A student newly assigned to a school that failed to make yearly progress during the prior school year would qualify (e.g., a first time student at such a school). A qualifying student that attended a qualifying school in one year generally would continue to be a qualifying student in subsequent years even if the local school made adequate yearly progress in a subsequent year. However, a student would not continue to be a qualifying student if the student could attend a new local school (not identified as failing to make adequate yearly progress) as a result of passing into a higher grade. For example, a 6th grade student who became a qualifying student because the student's local elementary school was designated as failing to make adequate yearly progress when the student was a 5th grader would not be a qualifying student during 7th grade if the student's local school for the 7th grade was a junior high school not so designated for the prior year. However, if the student's local elementary school went through the 8th grade, the student would be a qualifying student for the 6th, 7th, and 8th grades even if the local school made adequate yearly progress when the student was in the 6th and 7th grades. If a qualifying student at the beginning of a school year moved out of the local school's attendance area but continued to attend the same qualifying school for the rest of the school year, the student would continue to be a qualifying student for the rest of such year.

A qualifying school would be any public school (other than the local school), including a public charter school, making adequate yearly progress in the prior year or a private elementary or secondary school located in the United States. The definition of school would be determined under the applicable State law.

Effective date.--The proposal would be effective with respect to expenses incurred beginning with the 2002-2003 school year and through the 2006-2007 school year.

Analysis of Complexity and Policy Issues

Policy issues

The proposal would provide a subsidy for students enrolled in failing public schools to attend another public school or a private school. Proponents of the proposal argue that greater school choice would give children better opportunities for a quality education. Under this view, the critical point is not whether a school is public or private but simply whether the school can better educate the child. Proponents of the proposal point out that the tax credit is available only for students enrolled in schools that have been identified as failing to make adequate yearly progress and that it is appropriate for the Federal government to help students in such schools find alternatives. In addition, proponents argue that the proposal would help to reform failing public schools by forcing such schools either to improve standards or to lose students.

On the other hand, others argue that the proposal would take resources away from public schools and therefore would not lead to overall reform of the public school system. Others also argue that the proposal could lead to abuse by taxpayers who enrolled a qualifying child in a local school solely for the purpose of obtaining the tax credit and then transferring the child to a private school. Others also note that the proposal is available to taxpayers at all income levels and that it is not appropriate for the Federal government to provide a credit to those who can afford to send a child to a different school. In fact, some might argue that the amount of the credit is not enough to enable low-income parents to send their children to other schools, so those most in need of government assistance in securing a good education for their children will not benefit from the credit. Further, critics argue that the proposal does not ensure better educational choices for students because private schools are not subject to the same standards as public schools. For example, private schools are not subject to identification as failing or succeeding under the Elementary and Secondary Education Act, and thus could be a "failing" school without being identified as such. A related issue is the effectiveness of the education provisions underpinning the proposal. That is, if the education provisions do not adequately identify schools as failing or succeeding, then the credit would be less effective. The proposal also raises a question of constitutional law to the extent that some of the private schools benefiting from the subsidy are religious schools. In addition, some argue that home schools should not be supported by Federal subsidy, even if defined as a school under State law.

Complexity issues

The proposal would add a new and complex tax credit to the Code. The proposal contains a number of defined terms -- qualifying child, qualifying student, qualifying expenses, and qualifying school, which would multiply the potential for taxpayer uncertainty and likely would decrease administrative efficiency. In addition, the definition of qualifying expenses would present another version of what constitutes "qualified" educational expenses to a tax Code that already contains multiple definitions.[55] The same would be true for the definition of qualifying child, which has five varying definitions under present tax law.[56] If a taxpayer's educational expenses meet the requirements of more than one tax benefit (e.g., the proposal and a qualifying distribution from a Coverdell education savings account), the proposal would increase the transactional complexity for taxpayers choosing among education benefits. Taxpayers claiming the credit would be required to substantiate qualifying expenses, which would increase the record keeping burden on taxpayers. Taxpayers would need to monitor new local schools to know whether the qualifying student could attend such school as a result of passing into a higher grade. To administer the proposal properly, the IRS likely would have to create new tax forms and would have to verify that schools are not making adequate yearly progress. Further, regulatory guidance likely would be necessary.

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[55] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 122-26 (JCS-3-01), April 2001.

[56] See Id., at 44-66.

Prior Action

No prior action.

2. Deduction for teachers' out-of-pocket classroom expenses

Prior and Present Law

Under the laws in effect prior to January 1, 2002, an individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.[57] Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.

In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous itemized deductions, exceed two percent of the taxpayer's adjusted gross income. Itemized deductions subject to the two-percent floor are not deductible for minimum tax purposes. In addition, present law imposes a reduction on most itemized deductions, including the employer business expense deduction, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases-out the overall limitation on itemized deductions for all taxpayers. The 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 on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however this elimination of the limitation sunsets on December 31, 2010.

Contributions to a school may be eligible for a charitable contribution deduction under section 170. A contribution that qualifies both as a business expense and a charitable contribution may be deducted only as one or the other, but not both.

Subsequent to the submission of the President's budget to Congress, P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," provided for an above-the-line deduction of up to $250 of expenses incurred by kindergarten through grade 12 teachers (and other educators) for books, supplies (other than certain nonathletic supplies), computer equipment, and other equipment and supplementary materials used by the teacher in the classroom.

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[57] Treas. Reg. sec. 1.162-5.

Description of Proposal

The proposal would provide an above-the-line deduction for up to $400 of certain unreimbursed out-of-pocket expenses incurred by certain schoolteachers during a taxable year. Eligible schoolteachers would be those employed full time (by public entities or private schools) for an academic year ending during the taxable year and who teach in the United States at grade levels K through 12, including elementary and secondary school professionals such as principals, counselors, teacher's aides, librarians, and coaches. Eligible expenses would include the purchase of books, supplies, and equipment related to classroom instruction that become school property, as well as teacher training expenses related to current teaching positions. Travel or lodging expenses, or expenses related to religious instruction or activities would not be eligible expenses. Expenses claimed under the proposal could not also be claimed as itemized deductions. Taxpayers would be required to retain receipts for eligible expenses as well as a certification from a principal or other school official stating that the expenses qualified.

Effective date.--The proposal would be effective for expenses incurred in taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

Policy issues

The proposal is an effort to make fully deductible the legitimate business expenses of eligible schoolteachers. As described below, the expenses might otherwise be deductible except for the two-percent floor that applies to miscellaneous itemized deductions. As such, the proposal affirms the staff of the Joint Committee on Taxation's analysis that the two-percent floor increases pressure to enact above-the-line deductions on an expense-by-expense basis.[58] In addition to increasing complexity, the expense-by-expense approach is not fair to other taxpayers with legitimate business expenses that remain subject to the two-percent floor. For example, emergency response professionals incur similar unreimbursed expenses related to their employment, a deduction for which also has been separately proposed.[59]

The proposal would present compliance issues. One reason the two-percent floor was introduced was to reduce the administrative burden on the IRS to monitor compliance with small deductions. Some argue that any proposal that circumvents the two-percent floor will encourage cheating. Others argue that although cheating is a risk, the risk is the same for similarly situated taxpayers (e.g., independent contractors or taxpayers with trade or business income) who are not subject to the two-percent floor on similar expenses.

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[58] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 118-19 (JCS-3-01), April 2001.

[59] See the conference report to H.R. 1836, the "Economic Growth and Tax Relief Reconciliation Act of 2001," H. Rep. No. 107-84, at 169-70 (2001).

Complexity issues

Three provisions of present law restrict the ability of teachers to deduct expenses covered by the proposal: (1) the two-percent floor on itemized deductions; (2) the overall limitation on itemized deductions; and (3) the alternative minimum tax. The staff of the Joint Committee on Taxation has previously identified these provisions as sources of complexity and has recommended that such provisions be repealed.[60] These provisions would not apply to eligible expenses under the proposal. While repealing these provisions for all taxpayers would reduce the complexity of the Federal tax laws, the proposal likely will increase complexity.

Some may view the proposal as increasing simplification by providing for deductibility of certain expenses without regard to the present-law restrictions. However, several elements of the proposal would increase complexity. The proposal may increase recordkeeping requirements for taxpayers. Because of the present-law restrictions on deductibility, particularly the two-percent floor, some teachers with classroom expenses may not keep track of such expenses because they know they will not have sufficient expenses to exceed the two-percent floor. Taxpayers wishing to take advantage of the deduction would be required to keep records.

The proposal does not completely eliminate the need to apply the present-law rules. For example, a teacher with expenses in excess of the $500 cap under the proposal or with other miscellaneous itemized deductions may need to compute tax liability under the present-law rules as well as the proposal in order to determine which rules result in the lowest tax liability. In addition, the proposal does not cover all classroom expenses, but only those that meet the particular requirements of the proposal. Expenses that do not meet those requirements will remain subject to the present-law rules. Similarly, some expenses may be deductible under the proposal and eligible for tax benefits under other provisions. For example, certain teacher education expenses may be deductible under the proposal and eligible for a Hope or Lifetime Learning credit. Taxpayers with such expenses would need to determine tax liability in more than one way in order to determine which provisions result in the lowest tax liability. In addition, overlapping provisions increase the likelihood that some taxpayers inadvertently would claim more than one tax benefit with respect to the same expense.

Prior Action

The proposal was included in the President's fiscal year 2002 budget proposal.[61]

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[60] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 15, 88, 118 (JCS-3-01), April 2001.

[61] P.L. 107-147, the Job Creation and Worker Assistance Act of 2002," enacted a similar provision.

C. Health Care Provisions

1. Refundable tax credit for the purchase of health insurance

Present Law

Under present law, the tax treatment of health insurance expenses depends on whether a taxpayer is covered under a health plan paid for by an employer, whether an individual has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold.

An employer's contribution to a plan providing health coverage for an employee, and his or her spouse and dependents, is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their employee share of premiums on a pre-tax basis.

Self-employed individuals may deduct a portion of health insurance expenses for themselves and their spouse and dependents. The deductible percentage is 70 percent in 2002, and 100 percent in 2003 and all years thereafter. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. The deduction may not exceed the individual's self-employment income.

Other individuals who pay for their own health insurance may claim an itemized deduction for their health insurance premiums only to the extent that premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

Self-employed individuals and individuals employed by small employers maintaining a high-deductible health plan can accumulate funds in an Archer medical savings account ("MSA") on a tax-preferred basis to pay for medical expenses.

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), qualified beneficiaries are eligible to purchase continuation coverage under an employer-sponsored plan upon the occurrence of certain events that would otherwise result in loss of coverage, such as termination of employment. The employer may charge up to 102 percent of the average cost of the employer's health plan for continuation coverage. Depending on the circumstances, former employees and their dependents can elect to continue COBRA coverage for up to 18 to 36 months.

Description of Proposal

The proposal would provide a refundable tax credit for health insurance purchased by individuals who are under age 65 and do not participate in a public or employer-provided health plan. The maximum annual amount of the credit would be 90 percent of premiums, up to a maximum premium of $1,111 per adult and $556 per child (for up to two children). These dollar amounts would be indexed in accordance with the Consumer Price Index based on all-urban consumers. Thus, the maximum annual credit prior to any indexing of the premium limits,

would be $1,000 per adult and $500 per child (up to two children), for a total possible maximum credit of $3,000 per tax return.

The 90 percent credit rate would be phased-down for higher income taxpayers. Individual taxpayers filing a single return with no dependents and modified adjusted gross income of $15,000 or less would be eligible for the maximum credit rate of 90 percent. The credit percentage for individuals filing a single return with no dependents would be phased-down ratably from 90 percent to 50 percent for modified adjusted gross income between $15,000 and $20,000, and phased-out completely at modified adjusted gross income of $30,000.

Other taxpayers with modified adjusted gross income up to $25,000 would be eligible for the maximum credit rate of 90 percent. The credit percentage would be phased-out ratably for modified adjusted gross income between $25,000 and $40,000 if the policy covers only one adult, and for modified adjusted gross income between $25,000 and $60,000 if the policy (or policies) covers more than one adult.

Taxpayers claiming the credit would not be allowed to make contributions to an Archer MSA for the year the credit is claimed.

The credit would be claimed on the individual's tax return or on an advanced basis, as part of the premium payment process, by reducing the premium amount paid to the insurer. After implementation of the advanced payment option, the benefit of the credit would be available at the time that the individual purchases health insurance, rather than later when the individual files his or her tax return the following year. Health insurers would be reimbursed by the Department of the Treasury for the amount of the credit. Eligibility for the advanced credit option would be based on the individual's prior year return and there would be no reconciliation on the current year return.

Policies eligible for the credit would have to meet certain requirements, including coverage for high medical expenses.[62] Qualifying health insurance could be purchased through the non-group insurance market, private purchasing groups, State-sponsored insurance purchase pools, and State high-risk pools.

At the option of States, after December 31, 2003, the credit could be used by certain individuals not otherwise eligible for public health insurance programs to buy into privately contracted State-sponsored purchasing groups (such as Medicaid or SCHIP purchasing pools for private insurance or State government employee programs for States in which Medicaid or SCHIP does not contract with private plans). States could provide additional contributions to individuals who purchase insurance through such purchasing groups. The maximum State contribution would be $2,000 per adult (for up to two adults) for individuals with incomes up to 133 percent of the poverty level. The maximum State contribution would phase-down ratably, reaching $500 per adult at 200 percent of the poverty level. Individuals with income above 200 percent of the poverty level would not be eligible for a State contribution. States would not be allowed to offer any other explicit or implicit cross subsidies.

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[62] The proposal does not include details regarding the requirements policies must satisfy.

Effective date.--The credit would be effective for taxable years beginning after December 31, 2002. The advanced payment option would be available beginning in July 2003.

Analysis of Complexity and Policy Issues

Policy issues

In general

The proposal is intended to provide an incentive to uninsured individuals to purchase health insurance by providing assistance in paying premiums. Proponents of the proposal argue that the proposal will enable low-income individuals to purchase health insurance, thereby reducing the number of uninsured individuals.

Opponents of the credit argue that it would not be sufficient to make insurance affordable for many individuals and thus would not be utilized by many uninsured. For example, the credit may not improve the opportunity for coverage in the individual market for the elderly and individuals with chronic health problems if coverage is too expensive, even with the credit. In addition, opponents of the credit question whether the amount of the credit will be sufficient to allow many low-income individuals, regardless of age or health status, to purchase adequate health insurance coverage. They argue that the credit is too low to allow individuals to purchase a policy other than a very minimal policy, and that those most likely benefiting from the credit will be insurers. Proponents counter that the credit level is sufficient, and that individuals who purchase insurance as a result of the credit will be better off than they would be without insurance.

Some opponents are also concerned about the focus of the credit on insurance purchased in the individual market. They believe the individual market does not presently offer sufficient protections to purchasers, and that any credit for the purchase of coverage in the individual market should only be adopted if accompanied by modest reforms.

The proposal addresses some of the present-law differences in tax treatment between employer-subsidized health insurance and insurance purchased by individuals. Critics of the proposal might argue that providing a credit for the purchase of health insurance would undermine the current employment-based health insurance system by encouraging healthier individuals who can obtain less expensive coverage in the individual market to leave the employee pool, thus increasing the cost of insurance for the employees remaining in the pool. Further, some argue that the existence of the tax credit could cause some employers to not offer health benefits for their employees. This could cause the insurance market to turn into a predominantly individual market, which could result in an increase in the cost of health coverage for some individuals.

Others argue that the design of the credit will not cause employees to leave employers' plans, as the credit is targeted to low-income individuals who are less likely to have employer-provided health insurance. Additionally, the subsidy rate is phased out as income increases and there is a cap on the premium eligible for the subsidy.

Because of the limit on the number of children per family eligible for the credit, families with more than two children will receive a smaller benefit under the proposal. For example, a married couple with two children could be eligible for a credit up to $3,000, while a single parent with three children could be eligible for a maximum credit of only $2,000.

Some argue that the objective of the proposal to increase health insurance would be better served under a direct spending program, especially because the credit is refundable and does not require that the individual pay tax. Those opponents to the credit argue that expanding public programs would be a better alternative because such expansion would not create an incentive to leave employer-provided coverage and would make health insurance coverage more affordable and accessible. On the other hand, a spending program may provide less individual choice of health insurance options.

Advanced payment mechanism

The advanced payment feature of the credit raises numerous issues. The main argument in favor of providing the credit on an advanced basis is that many of the intended recipients would not be able to purchase insurance without the advanced credit. Because advancing the credit merely changes the timing of payment and does not reduce the cost of insurance (except for the time value of money), this argument is best understood not as making the insurance affordable, as is often stated, but rather in making it available to those who would not otherwise be able to arrange the financing to pay for the insurance in advance of receiving the credit. Given the target population of the credit, it might reasonably be argued that for many, other financing mechanisms, such as credit cards, loans from relatives or friends, personal savings, etc., would not be available, or would not be used even if available, and the best way to encourage individuals to buy insurance would be to provide the credit in advance, at the time of purchase of the insurance.

Some argue that the mechanism for delivering the credit on an advanced basis would not be effective. For example, basing eligibility on the prior year's income raises issues. Using prior year information may make the advanced payment option easier to administer, however, using the prior year data and not requiring reconciliation means that the credit will in some cases not reach those intended to receive it. For example, individuals could have low income in the current year when they need assistance in purchasing health insurance, but prior year income that is too high to qualify for the advanced payment of the credit. Such individuals would not be eligible to receive the credit on the advanced basis and in many cases, because of their decreased income, would remain uninsured.

It may also be argued that the advanced payment mechanism of the proposal is flawed because an individual could receive the credit as an advanced payment based on the prior year's income, even though ineligible for the credit because of the current year's income. Because there is no reconciliation required on the current year return, such individual would not be required to repay the amount of the advanced payment of the credit to the government. For example, a recently graduated student could have current year income of over $100,000, but prior year income of less than $15,000 because the individual was in school on a full-time basis. Such individual could be entitled to the $1,000 advanced payment of the credit even though the

current year income exceeds the credit income limitation. Thus, using prior year income may result in inefficiency regarding delivery of the credit.

Using current year data or requiring reconciliation would reduce this problem. Using current year data could, however, create other issues, such as making the mechanics of the advanced payment system work and enforcement issues. For example, it may be difficult in some cases to collect the additional tax owed by people who erroneously claimed the advance credit. Experience with the earned income credit shows that this could be the case.

The fact that the tax credit is refundable could lead to fraud and abuse by taxpayers, as it may be difficult for the IRS to successfully enforce against taxpayers claiming the credit even though ineligible. Similar to the earned income credit, it would be difficult for the IRS to timely detect fraudulent refunds issued to taxpayers.

Complexity issues

Creating a new tax credit adds complexity to the Code.   By providing additional options to individuals, the proposal may increase complexity because individuals will have to determine which option is best for them. A new tax credit will increase complexity in IRS forms and instructions, by requiring new lines on several tax forms and additional information in instructions regarding the tax credit. The new credit would also require IRS programming modifications.

The Code contains several provisions that provide benefits to taxpayers with children. These provisions have different criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child. The use of different tests to determine eligibility for a provision with respect to a child causes complexity for taxpayers and the IRS. Under the proposal, the definition of child for purposes of the credit is unclear. Depending on the definition of child used for purposes of the credit, additionally complexity may arise. Additionally, the credit adds new phase-outs to the numerous existing phase-outs in the Code, which increases complexity in several ways.

The advanced payment aspect of the credit also adds additional complexity to the Code. Taxpayers would have to use different income amounts to calculate the credit depending whether the credit is claimed on an advanced basis or on the current year tax return. The proposal may also increase complexity for insurance companies by adding administrative burdens with respect to the advanced payment of the credit.   Health insurers would be required to provide information statements to taxpayers receiving the credit on an advanced payment basis and to the IRS, including the policy number, the policy premium, and that the policy meets the requirements for a qualified policy.

Prior Action

A similar credit was contained in the President's fiscal year 2002 budget proposal.

2. Above-the-line deduction for long-term care insurance premiums

Present Law

Under present law, the Federal income tax treatment of qualified long-term care insurance expenses is similar to the treatment of health insurance expenses.[63] As is the case with health insurance expenses, the Federal income tax treatment of qualified long-term care insurance expenses depends on the individual's circumstances.

Individuals who purchase their own qualified long-term care insurance may claim an itemized deduction for the premiums, but only to the extent that eligible qualified long-term care insurance premiums, together with the individual's medical expenses exceed 7.5 percent of adjusted gross income.[64] The amount of qualified long-term care insurance premiums that may be taken into account in determining the amount allowed as an itemized deduction is limited as follows (for 2002): $240 in the case of an individual 40 years old or less; $450 in the case of an individual who is more than 40 but not more than 50; $900 in the case of an individual who is more than 50 but not more than 60; $2,390 in the case of an individual who is more than 60 but not more than 70; and $2,990 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Self-employed individuals may deduct a portion of qualified long-term care insurance premiums for the individual and his or her spouse and dependents. The deductible percentage of such premiums is 70 percent in 2002 and 100 percent in 2003 and thereafter.[65] The deduction applies to qualified long-term care insurance premiums, subject to the same dollar limits that apply for purposes of the itemized deduction, described above.

Employees can exclude from income 100 percent of qualified long-term care insurance paid for by the employee's employer. There is no dollar limit on this exclusion. Unlike health insurance, long-term care insurance cannot be provided under a cafeteria plan.

Payments made under a qualified long-term care insurance contract are excludable from gross income, subject to a dollar limitation in the case of contracts that provide for payment on a per diem or similar basis.

In order for a long-term care insurance contract to be a qualified long-term care insurance contract: (1) the contract must be guaranteed renewable; (2) the contract generally cannot provide for a cash surrender value or other money that can be paid, assigned, or pledged as a loan

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[63] The main difference between the tax treatment of qualified long-term care insurance and medical insurance is that long-term care insurance cannot be offered under a cafeteria plan.

[64] Sec. 213(d).

[65] The deduction for long-term care insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse.

or borrowed; (3) all refunds of premiums, and all policyholder dividends or similar amounts, under the contract are to be applied as a reduction in future premiums or to increase future benefits; and (4) the contract must meet certain consumer protection standards.[66] Contracts that provide for per diem or similar payments are subject to additional requirements.

The consumer protection provisions applicable to qualified long-term care insurance contracts require that (1) such contracts meet certain provisions under the model long-term care insurance act and regulations promulgated by the National Association of Insurance Commissioners, (2) the issuer of the contract discloses that the contract is intended to be a qualified policy, and (3) the issuer offer the policyholder a nonforfeiture provision meeting certain requirements.

Description of Proposal

The proposal would provide an above-the-line deduction for a percentage of qualified long-term care insurance premiums up to the dollar limitations that apply under the itemized deduction. The deduction would not be available to an individual covered under an employer-sponsored health plan unless the employee pays at least 50 percent of the cost of the coverage. The proposal would also impose new standards on qualified long-term care policies.[67]

The deductible percentage of qualified long-term care insurance premiums would be 25 percent in 2004, 35 percent in 2005, 65 percent in 2006, and 100 percent in 2007 and thereafter.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

Policy issues

In general

The present-law favorable tax treatment of qualified long-term care insurance contracts was adopted to provide an incentive for individuals to take financial responsibility for their long-term care needs.[68] In addition, the present-law rules serve to provide certainty with respect to the tax treatment of qualified long-term care insurance contracts. Prior to the adoption of the present-law rules, which generally are effective beginning in 1997, the tax treatment of qualified long-term care insurance was unclear. There were no specific rules with respect to such insurance, rather, the tax treatment depended on the applicability of the rules relating to medical

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[66] Sec. 7702B.

[67] Details of the new standards are not specified.

[68] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 336.

expenses and accident or health insurance, which involved a case by case determination. Thus, the present-law rules contribute to simplification of the tax laws by reducing uncertainty.

The proposal would provide additional tax incentives for the purchase of qualified long-term care insurance. Like the present-law rules, such additional tax incentives are designed to encourage individuals to provide for their long-term care needs. The proposal raises both tax policy and health policy issues.

From a health policy perspective, one issue is whether it is appropriate to provide more favorable tax treatment for the purchase of long-term care insurance than for the purchase of health insurance. If this proposal were adopted, persons would be able to deduct long-term care insurance premiums above-the-line, whereas individuals who purchase their own health insurance (and who are not self employed) could only deduct health insurance premiums under the itemized deduction for medical expenses. Some argue that health insurance is a more fundamental need than, or at least an equal need to, long-term care insurance and that it is not appropriate to provide more favorable rules for long-term care insurance. Proponents of the proposal argue that the President's fiscal year 2003 budget proposal contains other provisions, in particular, a tax credit for the purchase of health insurance, that address the need for health insurance. In addition, some argue that an additional incentive to purchase long-term care insurance is appropriate to encourage individuals to purchase the insurance when they are younger. Premiums for long-term care insurance typically have a level payment feature; that is, part of the premium is allocated to the cost of current coverage and part to future coverage. Some argue that additional tax benefits will encourage individuals to purchase such coverage at a young enough age so that premiums are more affordable.

From a tax policy perspective, it could be questioned whether providing an additional incentive for the purchase of long-term care insurance serves the tax policy goal of accurate income measurement. Implementing the social policy of encouraging the financing of long-term care needs through subsidies provided in the tax system arguably is inefficient. Some might criticize the proposal as providing a targeted subsidy for one type of insurance product for which there has been a weak market, rather than directly addressing the social policy issue of growing long-term care needs. On the other hand, some might point out that Congress has already provided subsidies to long-term care insurance through the tax law to encourage people to provide for long-term care needs, and that this proposal is consistent with the policy already expressed by Congress.

Complexity issues

The proposal may contribute to complexity in the tax system by providing different sets of rules for long-term care insurance and health insurance. If the tax rules for long-term care insurance are more favorable than for health insurance, there may be pressure to provide health insurance under a long-term care policy. Thus, many of the definitional issues that arose prior to the enactment of the present-law rules may again arise. The proposal would also add complexity in that it would increase the number of savings incentives in the tax law, each with different requirements.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal and in the Taxpayer Refund and Relief Act of 1999 as passed by the 106th Congress and vetoed by the President.

3. Allow up to $500 in unused benefits in a health flexible spending arrangement to be carried forward to the next year

Present Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage).

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[69] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[70] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[71] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the

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[69] Sec. 401(k).

[70] Prop. Treas. Reg. 1.125-2 Q&A-5(a).

[71] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[72]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage), (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year, (3) only reimburse medical expenses which meet the definition of medical care under section 213(d), (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan, (5) reimburse medical expenses which are incurred during the participant's period of coverage, and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[73]

Description of Proposal

The proposal would allow up to $500 of unused amounts in an employee's health FSA to be carried forward to the employee's account for the next plan year of the health FSA.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

In general

Under present law, the use-it-or-lose it rule generally causes employees to estimate the amount of health care expenses they are likely to incur during the year and to elect to contribute no more than that amount to a health FSA. Present law creates an incentive for employees to make a conservative estimate of anticipated health care expenses that are likely to be paid from an FSA in order to minimize the risk that amounts will be forfeited. The proposal would reduce this incentive by reducing the likelihood that amounts would be forfeited. The proposal is likely to increase the amount of contributions to health FSAs because some employees who currently do not make contributions to a health FSA because of the use-it-or-lose it rule will make contributions if the proposal is adopted and because some employees will increase contributions

[72] Prop. Treas. Reg. 1.125-2 Q&A-7(c).

[73] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

if the proposal is adopted. Such an expansion of FSAs raises both tax and health policy issues. The proposal has elements that may both increase and reduce complexity.

Tax policy, efficiency and health policy issues

Some argue that cafeteria plans in general and FSAs in particular undermine sound income tax policy because they allow employees to choose whether certain income is taxable. Such plans and arrangements, like other income tax exclusions, contribute to unfairness in the Federal tax system because they result in unequal treatment of taxpayers with the same economic income. For example, medical expenses paid or reimbursed through a cafeteria plan are excludable from gross income, whereas if such expenses are paid directly by the employee, are deductible only if the employee itemizes deductions and only if the employee's total medical expenses exceed 7.5 percent of adjusted gross income. Thus, a taxpayer who is covered by a cafeteria plan may have lower tax liability that a similarly situated taxpayer who is not covered by such a plan.

Some argue that cafeteria plans, including FSAs, promote an efficient use of recourses by giving employers and employees more flexibility to address the concerns of a diverse and changing workforce. Such plans permit each employee to structure his or her own benefit program and reduce the need for employers to provide an array of benefits that some employees do not need or do not want.

There is a difference of opinion as to whether cafeteria plans, including health FSAs, promote or undermine sound health policy. Such plans reduce the cost to the employee of health care expenditures by the amount of the tax subsidy provided by the exclusion. Thus, such plans lower the cost of health care to the individual and may provide an incentive for greater health care utilization than would occur in the absence of the exclusion. This is true of all tax-favored health plans, whether provided through a cafeteria plan or otherwise, but may be exacerbated in the case of health FSAs because such arrangements provide a tax subsidy for the first dollar of health care coverage.

On the other hand, some argue that the availability of health FSAs may reduce health expenses. Some employees may be more likely to choose a less costly health insurance plan if they know they have money available in a health FSA that can be used to pay for expenses not covered by insurance. If such expenses are not in fact incurred, then health care spending will be reduced. However, some argue that cafeteria health FSAs operate more to shift health care expenses from the employer to the employee rather than to reduce overall spending on health care.

Proponents of the proposal argue that the use-it-or-lose it rule contributes to excess health care expenditures because some employees will incur unnecessary expenses merely to avoid losing amounts in a health FSA. They argue that if the use-it-or-lose it rule is modified, then employees will not incur such expenses. Others argue that the use-it-or-lose it rule serves mainly to affect the timing of expenses (e.g., an employee may choose to purchase new glasses this year rather than next year if they have amounts in an FSA) rather than reducing overall expenses.

Complexity issues

The proposal has elements that may both increase and decrease tax law complexity. By providing additional options to employees, the proposal may increase complexity because employees will have to determine which option is best for them. The proposal may also increase the complexity for employers by adding new administrative burdens with respect to cafeteria plans. On the other hand, easing of the use-it-or-lose it rule is likely to reduce the time it takes for individuals to determine whether and how much to contribute to a health FSA.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal.

4. Provide additional choice with regard to unused benefits in a health flexible spending arrangement

Present Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage).

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[74] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[75] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[76] These rules apply with respect to a health FSA without regard to

[74] Sec. 401(k).

[75] Prop. Treas. Reg. 1.125-2 Q&A-5(a).

[76] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[77]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage), (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year, (3) only reimburse medical expenses which meet the definition of medical care under section 213(d), (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan, (5) reimburse medical expenses which are incurred during the participant's period of coverage, and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[78]

Description of Proposal

The proposal would allow up to $500 of unused amounts in an employee's health FSA to be distributed to the employee or contributed to a qualified cash or deferred arrangement ("401(k) plan"), tax-sheltered annuity ("403(b) plan"), governmental section 457 plan, or an Archer medical savings account ("MSA"). Amounts distributed to the employee would be includible in gross income and subject to employment taxes. Amounts contributed to a 401(k) plan or similar arrangement or an Archer MSA would be subject to the normal tax rules applicable to contributions to such arrangements. Thus, for example, amounts contributed to a section 401(k) plan would be subject to the limit on elective deferrals and subject to the nondiscrimination rules applicable to such plans.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

[77] Prop. Treas. Reg. 1.125-2 Q&A-7(c).

[78] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

Analysis of Complexity and Policy Issues

In general

Under present law, the use-it-or-lose it rule generally causes employees to estimate the amount of health care expenses they are likely to incur during the year and to elect to contribute no more than that amount to a health FSA. Present law creates an incentive for employees to make a conservative estimate of anticipated health care expenses that are likely to be paid from an FSA in order to minimize the risk that amounts will be forfeited. The proposal would reduce this incentive by reducing the likelihood that amounts would be forfeited. The proposal is likely to increase the amount of contributions to health FSAs because some employees who currently do not make contributions to a health FSA because of the use-it-or-lose it rule will make contributions if the proposal is adopted and because some employees will increase contributions if the proposal is adopted. Such an expansion of FSAs raises both tax and health policy issues. The proposal has elements that may both increase and reduce complexity.

Tax policy, efficiency and health policy issues

Some argue that cafeteria plans in general and FSAs in particular undermine sound income tax policy because they allow employees to choose whether certain income is taxable. Such plans and arrangements, like other income tax exclusions, contribute to unfairness in the Federal tax system because they result in unequal treatment of taxpayers with the same economic income. For example, medical expenses paid or reimbursed through a cafeteria plan are excludable from gross income, whereas if such expenses are paid directly by the employee, are deductible only if the employee itemizes deductions and only if the employee's total medical expenses exceed 7.5 percent of adjusted gross income. Thus, a taxpayer who is covered by a cafeteria plan may have lower tax liability that a similarly situated taxpayer who is not covered by such a plan.

Some argue that cafeteria plans, including FSAs, promote an efficient use of recourses by giving employers and employees more flexibility to address the concerns of a diverse and changing workforce. Such plans permit each employee to structure his or her own benefit program and reduce the need for employers to provide an array of benefits that some employees do not need or do not want.

There is a difference of opinion as to whether cafeteria plans, including health FSAs, promote or undermine sound health policy. Such plans reduce the cost to the employee of health care expenditures by the amount of the tax subsidy provided by the exclusion. Thus, such plans lower the cost of health care to the individual and may provide an incentive for greater health care utilization than would occur in the absence of the exclusion. This is true of all tax-favored health plans, whether provided through a cafeteria plan or otherwise, but may be exacerbated in the case of health FSAs because such arrangements provide a tax subsidy for the first dollar of health care coverage.

On the other hand, some argue that the availability of health FSAs may reduce health expenses. Some employees may be more likely to choose a less costly health insurance plan if they know they have money available in a health FSA that can be used to pay for expenses not

covered by insurance. If such expenses are not in fact incurred, then health care spending will be reduced. However, some argue that cafeteria health FSAs operate more to shift health care expenses from the employer to the employee rather than to reduce overall spending on health care.

Proponents of the proposal argue that the use-it-or-lose it rule contributes to excess health care expenditures because some employees will incur unnecessary expenses merely to avoid losing amounts in a health FSA. They argue that if the use-it-or-lose it rule is modified, then employees will not incur such expenses. Others argue that the use-it-or-lose it rule serves mainly to affect the timing of expenses (e.g., an employee may choose to purchase new glasses this year rather than next year if they have amounts in an FSA) rather than reducing overall expenses.

Complexity issues

The proposal has elements that may both increase and decrease tax law complexity. By providing additional options to employees, the proposal may increase complexity because employees will have to determine which option is best for them. The proposal may also increase the complexity for employers by adding new administrative burdens with respect to cafeteria plans and the plans and arrangements to which left over amounts in a cafeteria plan could be contributed. On the other hand, easing of the use-it-or-lose it rule is likely to reduce the time it takes for individuals to determine whether and how much to contribute to a health FSA.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal.

5. Permanently extend and reform Archer Medical Savings Accounts ("MSAs")

Prior and Present Law

In general

Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high

deductible health plan.[79] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,650 and no more than $2,500 in the case of individual coverage and at least $3,300 and no more than $4,950 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,300 in the case of individual coverage and no more than $6,050 in the case of family coverage.[80] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Taxation of distributions

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.[81] However, in any year for which a contribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by that individual generally are excludable from income only if the individual for whom the

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[79] Self-employed individuals include more than two-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

[80] These dollar amounts are for 2002. These amounts are indexed for inflation in $50 increments.

[81] This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[82] For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

Cap on taxpayers utilizing Archer MSAs

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the pilot period 1997-2002, only those individuals who (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer MSA participants) or (2) are employed by a participating employer are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.[83] However, if the threshold level is exceeded in a year, previously uninsured individuals would be subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of Archer MSAs established has not exceeded the threshold level.

Duration of Archer MSA pilot program

Without extension, after 2002, no new contributions could be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made Archer MSA contributions of at least $100 in the year 2001. Self-

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[82] The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even for an individual who is not an eligible individual.

[83] Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

employed individuals who made contributions to an Archer MSA during the period 1997-2002 also would have been able to continue to make contributions after 2002.

Subsequent to the submission of the President's budget to Congress, the Archer MSA program was extended through 2002 by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002."

Description of Proposal

Under the proposal, Archer MSAs would be made permanent. In addition, (1) the cap on the number of Archer MSAs and the employer size restriction would be removed, and (2) all individuals covered by a high deductible health plan, other than a health plan for which the individual is eligible to claim a refundable health care tax credit, would be eligible for Archer MSAs.

The Administration's proposal would modify the definition of high deductible health plan to include an annual deductible as low as $1,000 for individual coverage and $2,000 in other cases. Plans would also be permitted to provide up to $100 of coverage for allowable preventive services per covered individual each year (without counting the amount against the deductible).

The proposal also would allow contributions to an Archer MSA by the individual, the employer, or both, up to 100 percent of the maximum deductible under the plan, up to the applicable limit for the individual for the year. Under the proposal, contributions to Archer MSAs could be made through a cafeteria plan.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2002.

Analysis of Complexity and Policy Issues

In general

The proposal is intended to make the MSA market a more viable option for purchasing health insurance coverage and to give individuals more control over spending for medical expenses. Proponents argue that individual control over health insurance will result in individuals becoming more cost conscious in purchasing medical services, potentially reducing the growth of health care costs. Eliminating the restrictions on MSAs will make the use of the accounts attractive to more individuals.

Opponents argue that because high deductible insurance may be more attractive to individuals who are young and healthy, such individuals may leave employer-based health insurance pools, causing the cost of insurance held by less healthy individuals to increase. Opponents argue that this will lead employers to not offer health insurance coverage or to raise the percentage of premiums that employees must pay. Others argue that the cost difference will be minimal and that MSAs can be attractive to individuals with health problems who want individual choice of health care providers.

Because MSAs can be rolled-over indefinitely and withdrawn for non-medical purposes at retirement, opponents argue that MSAs would be used as tax-shelters, particularly by healthy, affluent individuals. Proponents argue that the rollover feature allows individuals to set aside money for future medical expenses.

Complexity issues

The proposal has elements that may both increase and decrease tax law complexity. By providing additional options to individuals, the proposals may increase complexity because individuals will have to determine which option is best for them. The proposal would decrease complexity by making the temporary MSA program permanent.

Prior Action

A similar proposal was contained in the President's fiscal year 2002 budget proposal.[84]

6. Provide an additional personal exemption to home caregivers of family members

Present Law

In order to determine taxable income, an individual reduces adjusted gross income by a dollar amount ($3,000 for 2002) for the personal exemption with respect to each of the individual's dependents that meet certain requirements. To qualify as a dependent under present law, an individual must: (1) be a specified relative or member of the taxpayer's household; (2) be a citizen or resident of the U.S. or resident of Canada or Mexico; (3) not be required to file a joint tax return with his or her spouse; (4) have gross income below the dependent exemption amount ($3,000 in 2002) if not the taxpayer's child; and (5) receive over half of his or her support from the taxpayer. If no one person contributes over half the support of an individual, the taxpayer is treated as meeting the support requirement if: (a) over half the support is received from persons each of whom, but for the fact that he or she did not provide over half such support, could claim the individual as a dependent; (b) the taxpayer contributes over 10 percent of such support; and (c) the other caregivers who provide over 10 percent of the support file written declarations stating that they will not claim the individual as a dependent.

Description of Proposal

The proposal would allow an additional personal exemption for each qualified family member with long-term care needs who resides with the taxpayer in the household the taxpayer maintains. A taxpayer would be treated as maintaining the household for the year only if the taxpayer furnishes more than one-half the cost of maintaining the household for the entire year. The proposal would deem the present-law support test to be satisfied if the taxpayer and the qualified family member with long-term care needs reside together for a specified period. The length of the specified period would depend on the relationship between the taxpayer and the qualified family member with long-term care needs. The specified period would be over half the

[84] P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," extended the Archer MSA program through 2002.

year if the individual is: (1) the spouse of the taxpayer, or (2) the ancestor of the taxpayer (including stepparents and in-laws). The specified period would be the full year for all other relatives and members of the taxpayer's household.

An individual would be considered to have long-term care needs if he or she were certified by a licensed physician (prior to the filing of a return claiming the credit) as being unable for at least 180 consecutive days to perform at least two activities of daily living ("ADLs") without substantial assistance from another individual, due to a loss of functional capacity (including individuals born with a condition that is comparable to a loss of functional capacity). As under the present-law rules relating to long-term care, ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

As an alternative to the 2-ADL test described above, an individual would be considered to have long-term care needs if he or she were certified by a licensed physician as, for at least 180 consecutive days: (a) requiring substantial supervision to be protected from threats to health and safety due to severe cognitive impairment and (b) being unable to perform at least one ADL or to engage in age appropriate activities as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

The taxpayer would be required to provide a correct taxpayer identification number for the individual with long-term care needs, as well as a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying physician. Failure to provide correct taxpayer and physician identification numbers would be subject to the mathematical error rule. Under that rule, the IRS may summarily assess additonal tax due without sending the individual a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Further, the taxpayer could be required to provide other proof of the existence of long-term care needs in such form and manner, and at such times, as the Secretary requires.

<u>Effective date</u>.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

Complexity issues

The addition of a new personal exemption with special criteria, while beneficial to taxpayers, adds complexity to the tax law.

The proposal would add new criteria for the additional personal exemption, relating to whether an individual has long-term care needs. The tests, related to activities of daily living and requiring physician certification, resemble present-law tests of whether long-term care insurance premiums may be deductible or excludible. However, the extension of these tests to the rules

relating to the personal exemption adds more factual determinations and certification requirements, resulting in increased complexity.

Although some taxpayers would no longer be required to keep records for purposes of the present-law support test, many of the same records would be necessary to substantiate the maintenance of the household test under the proposal. In addition, new records would be required with respect to physician certification under the 2-ADL test and the alternative test.

Policy issues

The proposal is intended to subsidize individuals who maintain a household that includes certain family members with long-term care needs. The practical effect of the proposal is to allow an additional personal exemption to individuals whose household includes such family members. It can be argued that the proposal has the positive social policy benefit of encouraging individuals to provide in-home care for family members with long-term care needs.

Proponents could argue that allowing an additional personal exemption in this case better reflects the individual's ability to pay taxes, because of the likelihood that family members with long-term care needs may have increased expenses associated with those needs. Thus, it could be argued, the proposal is unlikely to cause inaccurate measurement of income, even though its principal purpose may be to further a non-tax related social policy. Others may argue that the level of the subsidy is too small to induce the intended behavior. In some cases, the tax benefit will represent a windfall benefit to individuals who would have engaged in the behavior regardless of the additional tax benefit. In any case, opponents may argue that the tax law is not an efficient medium for the delivery of subsidies to individuals in order to further a social policy goal.

Prior Action

An identical proposal was included in the President's fiscal year 2002 budget proposal.

D. Exclude from Income of Disabled Individuals the Value of Employer-Provided Computers, Software and Peripherals

Present Law

The value of computers, software, or other office equipment provided by an employer for use in the home of an employee is generally excludable from income as a working condition fringe benefit to the extent the equipment is used to perform work for the employer (sec. 132). The value of such equipment is includible in income to the extent the equipment is used for personal purposes. If such equipment is used for both personal and business purposes, then a portion of the value may be excluded from income.

In general, employee business expenses are deductible as an itemized deduction, but only to the extent such expenses and other miscellaneous itemized deductions exceed two percent of adjusted gross income. Impairment-related work expenses are not subject to this two-percent floor. Impairment-related work expenses are expenses: (1) of a handicapped individual for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work; and (2) that are trade or business expenses (sec. 162). For these purposes, a handicapped individual means an individual who has a physical or mental disability (including but not limited to blindness or deafness) which for such individual constitutes or results in a functional limitation to employment or who has any physical or mental impairment (including, but not limited to, a sight or hearing impairment) which substantially limits one or more major life activities of such individual.

Description of Proposal

The proposal would provide an exclusion from income for the value of any computers, software or other office equipment provided to an individual with a disability by that individual's employer. The exclusion would be limited to equipment necessary for the individual to perform work for the employer at home but would not be limited to business use of such equipment. Therefore, the exclusion would apply to all use of such equipment, including use by the employee for personal purposes or to carry on a trade or business other than working as an employee of the employer. However, in order to qualify for the exclusion, the employee would be required to make substantial use of the equipment to perform work for the employer.

If the employer provided the employee with the use of the equipment at the end of its useful life, the proposal also would deem the value of such use to be zero for tax purposes.

The definition of an individual with a disability would be the same as the present-law definition used for impairment-related work expenses. Eligible employees would be required to provide their employer with a certification from a licensed physician showing that they meet the criteria for an individual with a disability in such form and manner as provided by the Secretary of the Treasury.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

Complexity issues

One purpose of the proposal may be a simplification purpose, that is, to reduce record keeping for disabled employees to whom an employer provides office equipment. While the proposal would eliminate the need to keep track of personal versus business use of covered equipment, it would nevertheless add a physician certification requirement. The reduction in record keeping requirements might be insignificant, on balance.

The proposal gives rise to new tax law complexity because it would add a new factual determination ("substantial" business use) as a criterion for the tax benefit it provides. The proposal does not specify what constitutes "substantial" business use for these purposes. Because any standard for making this determination would involve a factual inquiry, the proposal would increase the complexity of tax administration by increasing the likelihood of factual disputes and litigation. Some might argue that allowing an exclusion would be simpler, in that it would eliminate the issue of the amount of business use of covered equipment.

Policy issues

Under normal income tax principles, if an employer pays an employee cash, the cash is taxable as income to the employee regardless of whether the employee uses the cash to purchase a computer and software for personal use or whether the employee purchases other consumer goods for personal consumption. Thus, under normal income tax principles, when an employer provides any item of value to an employee, the value of the good or service provided to the employee should be included in the taxable income of the employee, because the provision of the good or service is a form of compensation. The proposal would exclude the value of computer hardware and software provided to certain employees for personal use from the taxable income of the employees.

If certain forms of compensation are not taxed to the employee, the employer is indifferent (the employer's outlay is deductible as compensation regardless of whether in cash or in kind), but the employee will find the untaxed forms of compensation more valuable. For example, if a taxpayer in the 15-percent income tax bracket sought to purchase a $1,000 computer system, the taxpayer would have to earn $1,176 in income in order to have the $1,000 after-tax income sufficient to purchase the computer system. If the employer can provide the computer system to the employee and the value of the system is excluded from the employee's taxable income, it is equivalent to the employee receiving a 15-percent discount on the price of the computer system. Alternatively, it is equivalent to the employee having received an additional $176 in compensation. More generally, for a taxpayer whose marginal income tax rate is t, if the employer can provide the computer system to the employee and the value of the system is excluded from the employee's taxable income, it is equivalent to the employee receiving a t-percent discount on the price of the computer system or, alternatively, it is equivalent to the employee having received an additional 1/(1-t) percentage increase in compensation. Generally, if the price of a good declines, consumers purchase more of the good. In this context, this could result in employees seeking more compensation in the form of untaxed computer goods and services and less in the form of taxable compensation.

Some may question the fairness of providing an implicit price subsidy for the use of computer hardware and software to some taxpayers (handicapped employees) and not to other taxpayers. On the other hand, handicapped employees may reap substantial benefits from the use of computers and policy makers may want to encourage the use of computers by handicapped persons in an effort to help mainstream such persons. However, if it is a policy goal to help mainstream handicapped employees, one might find it appropriate to include other goods and services to the list of potential forms of compensation that are excluded from the employee's taxable income if provided by the employer (e.g., modifications to automobiles to enable handicapped individuals to drive to work). If the policy judgment is that increased computer usage among handicapped individuals would have the greatest social return, one might question why the implicit subsidy is only provided in those cases where employers decide to make computers available, rather than by instituting a broader program of subsidies for the purchase of computers by handicapped individuals.

As noted above, exempting personal computer usage from the taxable income of handicapped employees also may be seen as effectively increasing the after-tax income of such employees. Handicapped individuals have lower earnings on average than other employees. In addition, proponents of the proposal would argue that handicapped employees are deserving of additional tax relief. On the other hand, providing tax relief in the form of computer services may not be as useful in meeting the needs of handicapped employees as would tax relief that resulted in greater take-home pay. Not all handicapped employees will find the computer service made available worth the discounted price for computer hardware and software that the tax exclusion creates. Some of these taxpayers would prefer to receive more of their compensation in the form of cash and less in the form of computer hardware and software.

Exempting certain forms of compensation from taxable income also has the potential create economic inefficiencies. Because certain employees do not bear the full cost of computer hardware and software, some employees may purchase more computer hardware and software than they need. By favoring computers, the proposal favors certain methods of enabling handicapped employees (those based on computer applications) over others. As a result, other strategies that could raise the well being of handicapped employees may be forgone.

Prior Action

An identical proposal was included in the President's fiscal year 2002 budget proposal.

E. Farm, Fish and Ranch Risk Management Accounts

Present Law

There is no provision of present law allowing the elective deferral of farm or fishing income.

Description of Proposal

The proposal would allow taxpayers engaged in an eligible business to establish Farm, Fish and Ranch Risk Management (FFARRM) accounts.

Contributions to a FFARRM account would be deductible and would be limited to 20 percent of the taxable income that is attributable to the eligible business. The deduction would be taken into account in determining adjusted gross income and would reduce income attributable to the eligible business for all income tax purposes other than the determination of the 20 percent of eligible income limitation on contributions to a FFARRM account. Under the proposal, contributions made on or before the due date (without regard to extensions) of the taxpayer's return for a taxable year would be deemed to have been made on the last day of such year. A six percent excise tax would be imposed on excess contributions.

A FFARRM account would be taxed as a grantor trust and any earnings would be required to be distributed currently. Thus, any income earned in the FFARRM account would be taxed currently to the farmer or fisherman who established the account.

Amounts may remain on deposit in a FFARRM account for up to five years. Any amount that has not been distributed by the close of the fifth year following the year of deposit would be deemed to be distributed and includible in the gross income of the account owner. Additionally, such deemed distributions would be subject to a 10-percent excise tax. Distributions for the year would be considered to first be made from the earnings that are required to be distributed. Additional amounts distributed for the year would be considered to be made from the oldest deposits.

Contributions to a FFARRM account would not reduce earnings from self-employment. Accordingly, distributions would not be included in self-employment income.

Distributions from a FFARRM account may not be used to purchase, lease, or finance any new fishing vessel, add capacity to any fishery, or otherwise contribute to the overcapitalization of any fishery. The Secretary of Commerce shall implement regulations enforcing this restriction.

An eligible business would be any trade or business of farming in which the taxpayer actively participates, including the operation of a nursery or sod farm or the raising or harvesting

of crop-bearing or ornamental trees.[85] An eligible business would also include the trade or business of commercial fishing in which the taxpayer actively participates. The term "commercial fishing" has the meaning given such term by section (3) of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. 1802) and includes the trade or business of catching, taking or harvesting fish that are intended to enter commerce through sale, barter or trade.

A taxpayer who has ceased to engage in an eligible business may not maintain a FFARRM account. If the taxpayer does not engage in an eligible business during two consecutive taxable years, the balance in the FFARRM account would be deemed to be distributed to the taxpayer on the last day of such two-year period.

If the taxpayer who established the FFARRM account dies, and the taxpayer's surviving spouse acquires the taxpayer's interest in the FFARRM account by reason of being designated as the beneficiary of the account at the death of the taxpayer, the surviving spouse would "step into the shoes" of the deceased taxpayer with respect to the FFARRM account. In other cases, the account would cease to be a FFARRM account on the date of the taxpayer's death and the balance in the account would generally be deemed distributed to the taxpayer on the date of death. The deemed distributions under these rules would be included in the gross income of the owner but would not be subject to an additional excise tax.

A FFARRM account would be a trust that is created or organized in the United States for the exclusive benefit of the taxpayer who establishes it. The trustee must be a bank or other person who demonstrates to the satisfaction of the Secretary that it will administer the trust in a manner consistent with the requirements of the section. At all times, the assets of the trust must consist entirely of cash and obligations which have adequate stated interest (as defined in section 1274(c)(2)) and which pay such adequate interest not less often than annually. The trust must distribute all income currently, and its assets may not be commingled except in a common trust fund or common investment fund. Additional protections, including rules preventing the trust from engaging in prohibited transactions or from being pledged as security for a loan, would be provided.

Penalties would apply in the case of excess contributions and failures to make required distributions.

Effective date.--The provision would be effective for taxable years beginning after December 31, 2003.

[85] An evergreen tree that is more than six years old when severed from the roots (and thus eligible for capital gains treatment on cutting) would not be considered an ornamental tree for this purpose.

Analysis of Complexity and Policy Issues

Policy issues

The proposal would permit a qualified business owner electively to reduce current year taxable income and invest the amount of the elective reduction. Any earnings on the investment would be taxable to the business owner in the future years in which investment earnings are realized and the original principal amount invested would be included in the business owner's taxable income in some future year at the business owner's discretion (but always within six years from the deposit of the principal amount). The proposal offers two tax benefits to the taxpayer. First, the taxpayer may defer the payment of tax on the initial deposit amount for up to six years. Generally under present law, current income is subject to tax and if the taxpayer invests some portion of current income, subsequent earnings on that investment are subject to tax. Under the proposal, the taxpayer does not have to pay any tax on the principal amount invested until a later date. That is, the taxpayer may invest that portion of current income that otherwise would be paid to the government and earn investment returns on that investment. Such an outcome can be thought of as the government loaning to the taxpayer an amount equal to the taxpayer's payment at a zero interest rate and the taxpayer investing those proceeds.

For example, assume an eligible taxpayer in the 27-percent income tax rate bracket earned $5,000 in income. Assume the available interest rate is five percent. Under present law, each $1,000 earned would give rise to a $270 tax liability, and thus the taxpayer would have a net of $730 to put in an account earning five percent per annum. The annual interest earning would be taxable. After netting annual tax payments on interest from the account and reinvesting the net return, the account would be worth $873 after five years. Under the proposal, the taxpayer could invest $1,000 in a FFARRM account instead of only $730. The annual interest earning would be taxable. After netting annual tax payments on interest from the account and reinvesting the net return, the account would be worth $1,196 after five years at which time the taxpayer would pay the deferred $270 tax liability, leaving the taxpayer with $926. In this example, using the proposed FFARRM account increases the value of the taxpayer's account by six percent over present law.

An alternative way to view the benefit of deferral is to recognize that deferral of tax is equivalent to a reduction in the effective rate of tax. One could calculate an income tax rate that, applied as under present law, left the taxpayer with the same net financial holdings as does the proposed FFARRM account when the FFARRM account is subject to the tax rates of present law. In the example above, an effective equivalent income tax rate would be 23.3 percent. In general, the longer funds are held in the FFARRM account and the greater the interest rate the greater the benefit from deferral. Table 3, below, calculates the effective tax rates assuming funds would be held in such accounts for a period of five years assuming, interest rates are either five percent or seven percent, and assuming that the taxpayer's statutory marginal income tax rate would otherwise be 15, 27, or 35 percent.

Table 3--Effective Marginal Income Tax Rate on Income Deposited in a Proposed FFARRM Account and Held for Five Years

	Effective Marginal Tax Rate		
	15% statutory marginal tax rate	27% statutory marginal tax rate	35% statutory marginal tax rate
Interest rate = .05	12.7	23.3	30.6
Interest rate = .07	12.1	22.3	29.4

Source: Joint Committee staff calculations

The second primary income tax benefit to the taxpayer from the proposed FFARRM account arises from the taxpayer's ability to choose the year (within a five-year period) that the taxpayer will distribute the principal contributed to the FFARRM account and recognize that amount as part of taxable income. Statutory marginal tax rates rise with income. If the taxpayer's income is variable from year to year, in some years the taxpayer may be in higher marginal income tax rate bracket than in other years. For example, if the taxpayer contributes $1,000 to a FFARRM account in a year in which the taxpayer is otherwise in the 27-percent marginal income tax bracket, as noted above, the taxpayer avoids a $270 tax liability currently. If, in one of the next five years, the taxpayer's income otherwise would place the taxpayer in the 15-percent marginal income tax bracket, the taxpayer could elect to distribute the $1,000 from the FFARRM account and incur a tax liability of $150. This produces a $120 tax saving. The FFARRM account would permit the taxpayer to shift taxable income from "good" years to "bad" years. Effectively, the FFARRM account permits the taxpayer to average income across a five-year period.

Proponents of the proposal observe that under the present-law income tax, marginal tax rates increase with income such that the overall system is progressive, that is, such that a higher income individual pays tax at a greater average rate (total tax divided by total income) than does a lower-income individual. As a consequence of this, a taxpayer, Mr. Smith, whose income is high one year and low the next will pay a greater total tax over the two-year period than would another taxpayer, Mr. Jones, whose income in each year equals the average of Mr. Smith's income. Proponents of the proposal observe that farming, ranching, and fishing are commercial endeavors whose profitability is variable and unpredictable. They argue that FFARRM accounts, by permitting averaging of the highs and the lows, promotes fairness among taxpayers when viewed over a period of years as opposed to looking solely at one year.

Proponents further argue that utilization of FFARRM will permit eligible taxpayers to better manage business risk and promote investment in qualifying enterprises. They note that promoting saving funds from a good year can help to provide resources in a bad year for the purchase of seed, feed, or yearlings. In the absence of the FFARRM account, the taxpayer may have to borrow (or borrow more). The FFARRM account may reduce a farmer or rancher from carrying a high mortgage of his or her land (on his or her vessel in the case of a fisherman), thereby reducing default risk and better ensuring the longevity of the farming, ranching, or fishing enterprise. Others note that the present-law income tax does not preclude farmers,

ranchers, and fisherman from setting aside funds from profitable years that can be used to finance operations in poor years.

Complexity issues

Although the proposal would be beneficial to taxpayers because it would provide for deferral of income not permitted under present law, the proposal would increase complexity in the tax law and in tax administration. Establishing FFARM accounts and keeping track of contributions to and distributions from the accounts would require new record keeping by taxpayers and would require the Internal Revenue Service to promulgate new tax forms and devote resources to administration of the provision. In addition, the excise tax that would be imposed on excess contributions would increase the complexity of tax administration by absorbing additional Internal Revenue Service enforcement resources. Because the proposal contemplates that financial institutions would be trustees of FFARM accounts, record keeping would also be required of those institutions, possibly complicating audits of the taxpayers utilizing the provision. In addition, it is likely that the provision would result in an increase in disputes and litigation between taxpayers and the IRS, at least in the first years that the provision came into effect, as the operation of the new rules became clear. Some might argue that a similar result could be achieved more simply by providing income averaging in lieu of the proposal.

Prior Action

A similar provision was included the President's fiscal year 2002 budget proposal.

F. Tax Credit for Developers of Affordable Single-Family Housing

Present Law

The low-income housing tax credit (the "LIHC") may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent qualified expenditures. The aggregate credit authority provided annually to each State is $1.75 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts. The $1.75 per resident cap is indexed for inflation.

Description of Proposal

The proposal would create a single-family housing tax credit. Eligible taxpayers generally would be the developer or investor partnership owning the qualified housing unit immediately prior to the date of sale to a qualified buyer. The maximum credit for each unit could not exceed the present value of 50-percent of the qualifying costs of that housing unit. This credit would be claimed over the five-year period beginning the later of the date of sale of the unit to a qualified buyer or the date a certificate of occupancy for that unit is issued. A qualified buyer would mean an individual with income of 80 percent (70 percent for families with less than three members) or less of area median income based initially on the 2000 census data. A qualified buyer would not have to be first-time homebuyer.

Similar to the present-law low-income rental housing tax credit, this credit would provide $1.75 of tax credit authority annually to each State for every resident in the State beginning in calendar year 2003. The $1.75 amount would be indexed for inflation beginning in calendar year 2004. Each State (or local government) would allocate its credit authority to the qualified developers or investor partnerships that own the housing unit immediately prior to the date of sale to a qualified buyer (or, if later, the date a certificate of occupancy was issued). Units in condominiums and cooperatives would be treated as single-family housing for purposes of the credit. Credits allocated to a housing unit would revert to the allocating agency unless expenditures equal to at least 10 percent of the total reasonably expected qualifying costs with respect to that housing unit were expended during the first six months after the allocation. Rules similar to the present-law LIHC rules would apply regarding plans on allocations, credit carryforwards, credit returns and a national pool of unused allocations.

The qualified developers or investor partnerships would claim the credit for the five years after the qualified property is sold to a qualified buyer. However, no credit would be allowed with respect to a housing unit unless that unit was sold within the one-year period beginning on the date a certificate of occupancy was issued with regard to that unit. Also, rules similar to the

present-law LIHC rules would apply to determination of eligible basis, present value calculations and reporting requirements.

A qualified homebuyer (not the developer or investor partnership) would be subject to recapture if the qualified homebuyer (or subsequent buyer) sells to a non-qualified buyer within three years of the initial sale of the qualified unit. The recapture tax would be the lesser of: (1) 80 percent of the gain upon resale, or (2) a recapture amount. The recapture amount would equal the value of the credits allocated to the housing unit being resold, reduced by 1/36th of that value for each month between the initial sale and the sale to the nonqualified buyer. If a housing unit for which any credit was claimed is converted to rental property within the initial five-year period then no deductions for depreciation or property taxes could be claimed with respect to such unit for the balance of that five-year period. The proposal does not provide how the qualified homebuyer (or subsequent buyer) would know what the recapture amount for their housing unit.

Effective date.--The proposal would be effective beginning in calendar year 2003.

Analysis of Complexity and Policy Issues

Complexity issues

The proposal would add to complexity in the tax law by creating a new tax credit with numerous detailed rules and significant record keeping requirements for both the taxpayer claiming the credit and subsequent homebuyers. This new credit, like the low-income rental housing credit upon which it is based, would be inherently complex and detailed, and would require significant additional paperwork by taxpayers. The proposal would require the creation of additional tax forms and would require the Internal Revenue Service to devote resources to the administration and enforcement of the rules under the proposal. Also, a system to identify qualified buyers and advertise qualified properties for sale to such buyers would need to be developed. This proposal could give rise to an increase in the number of individual taxpayers requiring third-party assistance in preparing their tax returns. The factual inquiries necessitated by the annual State credit authority cap, the per-unit expenditure requirements, the certification of buyer income levels, the time limits on subsequent sales, and the recapture rules applicable to homebuyers, would tend to lead to additional disputes, including litigation, between the IRS and taxpayers. In addition, adding a new incentive to home ownership without repealing or consolidating with present-law incentives (such as the low-income housing credit), which have a similar policy goal but have somewhat different requirements, would cause a proliferation of similar provisions, adding to tax law complexity.

Policy issues

Families with incomes less than the median income family are less often homeowners than are families with incomes above the median income. While many factors determine a family's decision to rent rather than own their own home, the price of a home creates two important financial factors that, at least temporarily, persuade families with incomes less than the median income to choose to rent rather than buy. First, the greater the price of a home, the greater the required down payment, and families generally must accumulate funds for the down

payment. Second, the greater the price of a home, the greater the monthly mortgage payment, and both lenders and prudent buyers generally limit monthly housing expenses by reference to a percentage of current income. In summary, lower housing prices would make it easier for families with incomes less than the median income to accumulate funds for a down payment and to qualify for a mortgage based upon their current income.

The local housing market, supply and demand, determine the price of available homes. An important factor in determining the market price is the cost of developing new properties or renovating old properties. A developer's expenses in the provision of housing can be thought of as consisting of two components: (1) the cost of the land; and (2) the cost of construction. The proposal would provide a developer a credit against his income tax liability related to qualified construction expenses for housing sold to a qualified homebuyer whose family income is 80 percent or less of area median income (70 percent or less for families comprised of one, two, or three individuals). In a sale to a qualifying homebuyer, the credit has the effect of subsidizing construction costs. As a consequence, the developer may be able to offer housing for sale to a qualifying homebuyer at a lower price than the developer's costs, or the local housing market, might warrant. The tax credit may enable the developer to earn an after-tax rate of return comparable or greater to that the developer would have earned had the same housing been sold to a non-qualifying homebuyer or comparable or greater to that the developer would have earned had the developer built other housing to be sold to a non-qualifying homebuyer in the same local housing market.

The statutory incidence of the proposal provides that the taxpayer developing the qualifying property claims the tax benefit. However, in a market economy the economic incidence can differ from the statutory incidence. All of the benefit could accrue to a buyer of the property in the form of reduction in purchase price (compared to an otherwise comparable home offered by a developer who has not received an allocation of the proposed tax credits) equal to the full present value of the tax credits[86] the developer/seller may claim under the proposal. Alternatively, there may be no change in purchase price (compared to an otherwise comparable home offered by a developer who has not received an allocation of the proposed tax credits), in which case the entire economic benefit of the tax credits would accrue to the developer/seller claiming the credits under the proposal. Generally the more responsive purchasers are to changes in the market price, the greater will be the proportion of the economic incidence of a tax benefit that accrues to the seller. The more responsive sellers are to changes in the market price, the greater will be the proportion of the economic incidence of a tax benefit that

[86] The proposal would determine the present value of the tax credits as provided under present-law Code section 42 (the low-income housing credit). The present value calculation prescribed in subsection 42(b) was based on a marginal income tax rate applicable to the highest income taxpayers of 28 percent. Subsequent changes in the marginal income tax rate structure, including changes enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, have established marginal income tax rates other than 28 percent to be applicable to the highest income taxpayers. Thus, the present value calculation of the proposal may not reflect the actual present value to the taxpayer.

accrues to the purchaser.[87] For example, if there are relatively few properties of a comparable type and it is difficult to obtain land or building permits to build more such properties, the more likely it will be that qualifying homebuyers bid against one another for a property. By bidding up the sales price of the property, more of the economic benefit of the tax credit accrues to the seller. Oppositely, if there are relatively few qualified buyers, but there are several potential developers who have credit allocations and can easily supply housing for sale, the developers may compete against each other to sell to a qualifying buyer by lowering the price they charge to such buyers. By lowering the price of the property under competitive pressure, more of the economic benefit of the tax credit accrues to the buyer.

Because of the diversity in market conditions of different local housing markets, it is not possible to predict whether buyers or sellers are likely to be the primary economic beneficiary of the proposed tax credit. The proposal requires that the credit may only be claimed for sales that occur within one year of the property being certified for occupancy. The time limit may exert pressure on developers to reduce the price of the property in order to sell it before the one-year period expires. On the other hand, the limit on the number of properties on which the credit may be claimed may impose a supply constraint. Potential qualifying buyers could bid against one another, keeping the sales price higher than it otherwise might be. Even if the economic beneficiary were to be the developer, the developer may only claim the credit if a family with an income of less than 80 percent of the area median income is the purchaser. Therefore, even if such a family did not receive a substantial price discount, if the developer sold to such a family, rather than a non-qualifying family, the goal of increasing home ownership by families with incomes less than 80 percent of the area median income may have been advanced.

The proposal defines qualifying buyers by reference to their annual income at the time of purchase. As noted above, a lower proportion of families with incomes less than area median income are homeowners than are families with incomes above the area median income. It is also the case that families headed by individuals 30 years old or younger are more likely to have incomes less than the area median income than are families headed by individuals over 30 years of age. This arises because most individuals' earning power increases with experience and job tenure. As the family's earners age, the family is more able to accumulate funds for a down payment and have sufficient monthly income to qualify for a mortgage on a home. Data on homeownership by age are consistent with this scenario. In 1999, the percentage of household owner-occupiers among households headed by an individual less than 35 years old was 39.7 percent. The percentage of household owner-occupiers among households headed by an individual 35 to 44 years old was 67.2 percent. The percentage of household owner-occupiers among households headed by an individual 65 years old or older was 80.1 percent.[88] By

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[87] Economists measure the responsiveness to demand and supply to price changes by reference to the "price elasticity of demand" and the "price elasticity of supply." The greater the price elasticity of demand relative to the price elasticity of supply, the greater the economic incidence falls to the benefit of purchasers. The greater the price elasticity of supply relative to the price elasticity of demand, the greater the economic incidence falls to the benefit of the seller.

[88] U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States 2000.*

targeting the credit based on annual income, the proposal may provide benefit to two distinct types of families. The proposal would provide benefit both to those families whose income, year-in, year-out falls below 80 percent of area median and who, consequently, may otherwise always find down payment and monthly mortgage servicing requirements a hurdle to homeownership. The proposal also would provide a benefit to families whose income growth would permit them to own a home without assistance as the family's income grows through time. For such families the proposal may only accelerate their ultimate status as a homeowner.

Some observers may find some unfairness in the proposal's definition of qualifying family. Under the proposal, the Smith family, whose income is less than 80 percent of the area median income, and the Jones family, whose income is above 80 percent of the area median income, could bid on the same property. If the Smith family offered $95,000 for the property and the Jones family offered $100,000, under the proposal, the Smith's offer could dominate the Jones's offer on an after-tax basis to the seller. The Smith and Jones families could have very similar incomes. A modest raise may have pushed the Jones family above the qualifying income threshold and thereby denied the Jones family the opportunity to acquire the home or it may require the Jones family to offer even more if they hope to acquire the home.

Some opponents of the proposal question the necessity of providing additional benefits to homeownership. They note that homeownership rates are above 60 percent[89] and homeownership receives preferential treatment under the present income tax as mortgage interest, home equity interest, and property tax payments are deductible expenses and that for many taxpayers any capital gain on the income from the sale of a principal residence is excluded from income. In addition, they note that, under present law, States may issue qualified mortgage bonds to lower the mortgage costs of middle and lower-middle income families who seek to acquire a home. That is, the qualified mortgage bond program generally targets the financial needs of the same population. Proponents of efforts to increase homeownership observe that homeownership helps support strong, vital communities and participatory democracy. In particular, they observe, the quality of life in distressed neighborhoods can be improved by increasing homeownership. In such neighborhoods the costs of renovation or new construction may exceed the current market value of housing in such neighborhoods and that a State allocation mechanism for the proposed credits may be able to direct qualifying investments to such areas where the social return to homeownership is particularly large.

Prior Action

An identical proposal was included in the President's fiscal year 2002 budget proposal.

[89] In 1999, of 104.9 million occupied housing units nationwide, 70.1 million were owner-occupied. U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States 2000*.

G. Individual Development Accounts

Present Law

Individual development accounts were first authorized by the Personal Work and Responsibility Act of 1996. In 1998, the Assets for Independence Act established a five-year $125 million demonstration program to permit certain eligible individuals to open and make contributions to an individual development account. Contributions by an individual to an individual development account do not receive a tax preference but are matched by contributions from a State program, a participating nonprofit organization, or other "qualified entity." The IRS has ruled that matching contributions by a qualified entity are a gift and not taxable to the account owner.[90] The qualified entity chooses a matching rate, which must be between 50 and 400 percent. Withdrawals from individual development account can be made for certain higher education expenses, a first home purchase, or small business capitalization expenses. Matching contributions (and earnings thereon) typically are held separately from the individuals' contributions (and earnings thereon) and must be paid directly to a mortgage provider, university, or business capitalization account at a financial institution. The Department of Health and Human Services administers the individual development account program.

Description of Proposal

The proposal would provide for a nonrefundable tax credit for an eligible entity (i.e., qualified financial institutions, qualified nonprofits organizations and qualified Indian tribes) that has an individual development account program in a taxable year. The tax credit would be equal to the amount of matching contributions made by the eligible entity under the program per account (up to $500 per taxable year) plus $50 for each individual development account maintained during the taxable year under the program. Except in the first year that each account is open, the $50 credit would be available only for accounts with a balance of more than $100 at yearend. The amount of the credit would be adjusted for inflation after 2002. The $500 amount is rounded to the nearest multiple of twenty dollars. The $50 amount is rounded to the nearest multiple of five dollars. No deduction or other credit would be available with respect to the amount of matching funds taken into account in determining the credit.

The credit would apply with respect to the first 900,000 individual development accounts opened before January 1, 2008, and with respect to matching funds for participant contributions that are made after December 31, 2002, and before January 1, 2010.

Nonstudent U.S. citizens or legal residents between the ages of 18 and 60 (inclusive) that meet certain income requirements would be eligible to open and contribute to an individual development account. The income limit would be modified adjusted gross income of $20,000 for single filers, $40,000 for joint filers, and $30,000 for head-of-household filers.[91] Eligibility

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[90] Rev. Rul. 99-44, 1999-2 C.B. 549.

[91] Married taxpayers filing separate returns would not be eligible to open an IDA or to receive matching funds for an IDA that is already open.

in a taxable year would be based on the previous year's modified adjusted gross income and circumstances (e.g., status as a student). Modified adjusted gross income would be adjusted gross income, plus certain items that are not includible in gross income. The proposal does not specify which items are to be added. The income limits would be adjusted for inflation after 2002. This amount is rounded to the nearest multiple of 50 dollars.

Under the proposal, an individual development account must: (1) be owned by the eligible individual for whom the account was established; (2) consist only of cash contributions; (3) be held by a person authorized to be a trustee of any individual retirement account under section 408(a)(2)); and (4) not commingle account assets with other property (except in a common trust fund or common investment fund). These requirements must be reflected in the written governing instrument creating the account. The entity establishing the program would be required to maintain separate accounts for the individual's contributions (and earnings therein) and matching funds and earnings thereon.

Contributions to individual development accounts by individuals would not be deductible and earnings thereon would be taxable to the account holder. Matching contributions and earnings thereon would not be taxable to the account holder.

The proposal would permit individuals to withdraw amounts from an individual development account for qualified expenses of the account owner, owner's spouse, or dependents as well as nonqualified expenses subject to certain restrictions. Qualified expenses include qualified: (1) higher education expenses (as generally defined in section 529(e)(3)**;** (2) first-time homebuyer costs (as generally provided in section 72 (t)(8); (3) business capitalization or expansion costs (expenditures made pursuant to a business plan that has been approved by the financial institution, nonprofit, or Indian tribe); (4) rollovers of the balance of the account (including the parallel account) to another individual development account for the benefit of the same owner; and (5) final distributions in the case of a deceased account owner. Withdrawals for qualified expenses must be paid directly to the unrelated third party to whom the amount is due, except in the case of expenses under a qualified business plan, rollover, or final distribution. Such withdrawals generally would not be permitted until the account owner completes a financial education course offered by a qualified financial institution, qualified nonprofit organization, Indian tribe or governmental entity. The Secretary of the Treasury (the "Secretary") would be required to establish minimum standards for such courses. Withdrawals for nonqualified expenses may result in the account owner's forfeiture of some amount of matching funds.

The qualified entity administering the individual development account program would generally be required to make quarterly payments of matching funds on a dollar-for-dollar basis for the first $500 contributed by the account owner in a taxable year. This dollar amount would be adjusted for inflation after 2002. Matching funds may be provided also by State, local, or private sources. Balances of the individual development account and parallel account would be reported annually to the account owner. If an account owner ceased to meet eligibility requirements, matching funds generally could not be contributed during the period of ineligibility. Any amount withdrawn from a parallel account shall not be includible in an eligible individual's gross income or the account sponsor's gross income.

Qualified entities administering a qualified program would be required to report to the Secretary that the program is administered in accordance with legal requirements. If the Secretary determined that the program was not so operated, the Secretary would have the power to terminate the program. Qualified entities also would be required to report annually to the Secretary information about: (1) the number of individuals making contributions to individual development accounts; (2) the amounts contributed by such individuals; (3) the amount of matching funds contributed; (4) the amount of funds withdrawn and for what purpose; (5) balance information; and (6) any other information that the Secretary deems necessary.

The Secretary would be authorized to prescribe necessary regulations, including rules to permit individual development accounts program sponsors to verify eligibility of individuals seeking to open accounts. The Secretary would also be authorized to provide rules to recapture credits claimed with respect to individuals who forfeit matching funds.

Effective date.--The proposal would be effective for taxable years ending after December 31, 2002, and beginning before January 1, 2010.

Analysis of Complexity and Policy Issues

Complexity issues

In general, adding this new credit to the tax law would tend to increase the complexity of the tax law and would require additional Internal Revenue Service resources to be devoted to administration of the provisions and to enforcement activities. The individual development account proposal would require additional record keeping by financial institutions benefiting from the credit and also by account holders. The annual reporting requirements of the individual development account program would increase the paperwork burden on individuals and financial institutions utilizing the provision. Arguably, the proposal would also add complexity in that it would increase the number of savings incentives in the tax law, each with different requirements. Some might argue that consolidation of these incentives would serve to simplify tax law and tax administration.

Policy issues

The proposal is intended to encourage individuals to save by providing a subsidy to saving. Proponents argue that many individuals have sufficiently low income that saving is difficult, and that the subsidy will help these individuals to accumulate savings, as well as to become more financially literate through the programs required to be provided by the eligible entities that may offer IDAs.

Opponents may argue that the generosity of the subsidy, which provides an immediate 100 percent return to the individual's contribution, makes the program more like an income transfer program and does not provide a realistic picture of the normal returns to saving. Others note that the cap on the number of accounts to which the credit would apply creates the potential for unfair tax treatment of similarly situated individuals, and may effectively allow financial and other eligible institutions to pick and choose the recipients of tax benefits. Additionally, individuals without ready access to eligible institutions are disadvantaged with respect to receiving a tax benefit for saving under the proposal.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal.

H. Environment-and Conservation-Related Provisions

1. Permanently extend expensing of brownfields remediation cost

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[92] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at, or on, which there has been a release (or potential release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas. The chief executive officer of a State, in consultation with the Administrator of the EPA, is authorized to designate an appropriate State environmental agency. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

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[92] *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under this provision.

Eligible expenditures are those paid or incurred before January 1, 2004.

Description of Proposal

The proposal would eliminate the requirement that expenditures must be paid or incurred before January 1, 2004, to be deductible as eligible environmental remediation expenditures. Thus, the provision would become permanent.

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

Policy issues

The proposal to make permanent the expensing of brownfields remediation costs would promote the goal of environmental remediation and remove doubt as to the future deductibility of remediation expenses. Removing the doubt about deductibility may be desirable if the present-law expiration date is currently affecting investment planning. For example, the temporary nature of relief under present law may discourage projects that require a significant ongoing investment, such as groundwater clean-up projects. On the other hand, extension of the provision for a limited period of time would allow additional time to assess the efficacy of the law, adopted only recently as part of the Taxpayer Relief Act of 1997, prior to any decision as to its permanency.

The proposal is intended to encourage environmental remediation, and general business investment, at contaminated sites. With respect to environmental remediation tax benefits as an incentive for general business investment, it is possible that the incentive may have the effect of distorting the location of new investment, rather than increasing investment overall.[93] If the new investments are offset by less investment in neighboring, but not qualifying, areas, the neighboring communities could suffer. On the other hand, the increased investment in the qualifying areas could have spillover effects that are beneficial to the neighboring communities.

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[93] For a discussion of the economic effects of targeting economic activity to specific geographic areas, see Leslie E. Papke, "What Do We Know About Enterprise Zones," in Jim Poterba, ed., *Tax Policy and the Economy* (Cambridge, MA: The MIT Press), 1993.

Complexity Issues

By making the present law provision permanent, the proposal may simplify tax planning and investment planning by taxpayers by providing more certainty. However, in general, the proposal would treat expenditures at certain geographic locations differently from otherwise identical expenditures at other geographic locations. Such distinctions generally require additional record keeping on the part of taxpayers and more complex tax return filings. Concomitantly, such distinctions increase the difficulty of Internal Revenue Service audits.

Prior Action

The special expensing for environmental remediation expenditures was enacted as part of the Taxpayer Relief Act of 1997. In 2000, an act Making Omnibus Consolidated and Emergency Supplemental Appropriations for Fiscal Year 2001 expanded the class of properties to which section 198 may apply and extended the expiration to December 31, 2003. Proposals to make section 198 permanent were included in the President's fiscal year 1999, fiscal year 2000, and fiscal year 2001 Budget Proposals.

2. Exclude 50 percent of gains from the sale of property for conservation purposes

Present Law

Income tax treatment of dispositions of land

Capital gains treatment

In general, gain or loss reflected in the value of an asset is recognized for income tax purposes at the time the taxpayer disposes of the property. On the sale or exchange of capital assets held for more than one year, gain generally is taxed to an individual taxpayer at a maximum marginal rate of 20 percent. However, gain attributable to real estate depreciation deductions that were previously claimed against ordinary income is taxed at a maximum marginal rate of 25 percent. Losses from the sale or exchange of capital assets are deductible only the extent of the gains from the sale or exchange of other capital assets, plus, in the case of individuals, $3,000.

Land is a capital asset, unless it is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or it is used in the taxpayer's trade or business. In addition, if the gains from property, including land, used in a taxpayer's trade or business exceeds the losses from such property, the gains and losses are treated as capital gains.

Deferral of gain or loss

Several provisions allow a taxpayer to defer gain when property, including land, is disposed of. For example, gain or loss is deferred if land held for investment or business use is exchanged for property of a like kind (generally defined to include other real estate) (sec. 1031). Likewise, gain or loss is deferred if land is condemned and replaced with other property of a like kind (sec. 1033(g)).

Income tax provisions relating to contributions of capital gain property and qualified conservation interests

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (secs. 170, 2055, and 2522 respectively).

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed.

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally is not allowable as a charitable deduction unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund.

Capital gain property

Capital gain property is property, which if sold at fair market value at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer'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. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined

as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of a historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryforward rules of other charitable contributions of capital gain property.

Description of Proposal

The proposal would provide that a taxpayer may exclude from his or her income, both under the regular and the alternative minimum tax, 50 percent of the gain realized from the sale of land (or an interest in land or water) to a qualified conservation organization for conservation purposes. The income not excluded would be taxed as capital gain income eligible for the alternative rate schedule of present law. The exclusion would be computed without regard to improvements.

To be eligible for the exclusion, the taxpayer or a member of the taxpayer's family would have to have owned the property for the three years immediately preceding the date of the sale. The taxpayer would not be eligible for the exclusion in the case of property sold pursuant to a condemnation order, but the taxpayer would be eligible for the exclusion in the case of property sold in response to the threat or imminence of a condemnation order.

A qualified conservation organization would be either a governmental unit or a charity that is a qualified organization under present law Code section 170(h)(3) and that is organized and operated primarily for conservation purposes. Conservation purposes would include the preservation of land areas for outdoor recreation by, or the education of, the general public; the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or the preservation of open space where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy.

The buyer would provide a written statement representing that it is a qualified conservation organization and that it intends to hold the property exclusively for conservation purposes and not to transfer it for valuable consideration other than to a qualified conservation in a transaction that would qualify under the proposal if the qualified conservation organization were a taxable person.

Sales of partial interests in property also would qualify if the sale meets the present law standards for contributions of partial interests as described above.

Effective date.--The proposal would be effective for sales on or after January 1, 2004.

Analysis of Complexity and Policy Issues

Policy issues

In general, for sales of real estate, the maximum tax rate applied to capital gain income (excluding improvement) is 20 percent for taxpayers who would otherwise be in the 27 percent, 30 percent, 35 percent, and 38.6 percent ordinary income tax brackets.[94] If such a taxpayer sold conservation property to a qualifying conservation organization, after the 50-percent exclusion, the effective tax rate on the gain income would be 10 percent.[95] Per $1,000 of gain, the proposal could produce a benefit of up to $100 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price.[96] The proposal seeks to increase sales of conservation property to qualifying conservation organizations by making it possible to for the seller to reap a higher after-tax return by selling his or her property to the qualifying conservation organization than by selling to a non-qualifying buyer.

The simple calculations above may suggest that the seller would reap the full benefit of the lower effective tax rate. However, qualifying conservation organizations, recognizing that their purchase of property can qualify a taxpayer for a lower effective tax rate (a higher after-tax return) may bid less than they otherwise might in the knowledge that the highest offer may not be selected by a taxpayer who is informed of the tax benefits of the lower bid. In this sense, the proposal is equivalent to the Federal Government partially subsidizing the purchase of conservation property selected by the qualifying conservation organization. From the

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[94] The tax rates stated in the text are those applicable for 2002. Under present law, by 2006, these four tax rates will be reduced to 25 percent, 28 percent, 33 percent, and 35 percent. Under present law, in 2006, the maximum tax rate applied to capital gain income would be 20 percent (18 percent for certain property held for five years or more). For taxpayers in the 15 and 10-percent income tax brackets in 2002 and beyond, the maximum tax rate on capital gain income is 10 percent (eight percent for property held for five years or more).

[95] In the case of a taxpayer otherwise in the 15-percent or 10-percent marginal income tax bracket, after the exclusion, an application of the alternative 10 percent tax rate on income from capital gain, the effective tax rate on the gain income would be five percent.

[96] In the case of a taxpayer otherwise in the 10 or 15-percent marginal income tax brackets, per $1,000 of gain, the proposal could produce a benefit of up to $50 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price. For these taxpayers the benefit would be up to $40 in the case of property held for five years or more (an effective four percent tax rate rather than an eight percent tax rate). Beginning in 2006, for taxpayers otherwise in marginal income tax brackets above the 15-percent bracket, the potential maximum benefit for sales of property held for five years or more would be $90 (an effective nine percent tax rate rather than an 18 percent tax rate).

calculations above, by lowering the effective tax rate, the Federal government would be effectively contributing as much as 10 percent of the purchase price of the property.[97]

The extent to which the benefit of the proposed exclusion accrues to the taxpayer selling the property or to the qualifying conservation organization purchasing the property depend upon the demand for the property and the extent to which other similar properties also are offered for sale. If one qualifying conservation organization is bidding against other persons for a property, in general one might expect that the qualifying conservation organization might be able to accrue a substantial portion of the benefit of the lower effective tax rate. While the persons not representing qualifying conservation organizations would bid based on what they believe the market value of the property to be, the qualifying conservation could bid less, and as demonstrated above, the seller would find it in his or her interest to accept the lower bid of the qualifying conservation organization. To receive the entire benefit of the lower effective tax rate, the qualifying conservation organization would have to know the tax position of the seller (see discussion of complexity below). In practice, such knowledge would not be available to the qualifying conservation organization and conservative bidding would result in the qualifying conservation organization accruing less than the full benefit.

On the other hand, if several qualifying conservation organizations bid against each other on the same property, as they compete with price offers they would transfer most of the benefit from the exclusion to the taxpayer selling the property.

Complexity issues

In its report,[98] the staff of the Joint Committee on Taxation identified the taxation of income from capital gains as an area of complexity in the individual income tax. The staff of the Joint Committee on Taxation has identified nine different categories of capital gain, often with multiple rates of tax applying within each category depending upon the taxpayer's circumstance. Present law requires a holding period of one year or more and five years or more for a taxpayer to avail him or herself of the benefit of the alternative tax rates applicable to capital gain income. The proposal layers an exclusion for the sale of certain assets on top of the present law alternative rate schedule. The proposal would create a new three-year holding period requirement. This would require additional computation, instructions, and a longer form for individuals who recognize gains that qualify for the exclusion of the proposal and also have other gain income. While relatively few taxpayers would recognize qualifying gains in any one year,

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[97] The percentage in the text assumes that the taxpayer selling the property has a zero basis in the property. Thus, the percentages in the text represent an upper bound on the Federal government's effective share of the purchase price. In the case of property sold by a taxpayer otherwise in the 10 or 15-percent marginal income tax brackets or in the case of property sold held for five years or longer, the comparable percentages would be lower.

[98] Joint Committee on Taxation, *Study of the Overall State f the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 97-108, (JCS-3-01), April 2001.

those taxpayers who recognize other gain income will have a more complex form to work through.

By its design, the proposal makes economic decisions more complicated as a taxpayer's net rate of return to the sale of property would depend upon the buyer's identity as well as the buyer's purchase offer. In theory, if the proposal were to have the desired incentive effect, the taxpayer would weigh the offer price of a qualifying conservation organization against competing offers from other persons by calculating his or her after-tax position. Such calculations are more complex than comparing the dollar purchase offers of competing buyers. From the buyer's side, if the qualifying conservation were to attempt to utilize the proposal to its benefit by offering a lower price to the seller, the organization would have to make estimates, or consult with the seller, regarding the seller's tax position for the year of the sale. This would include researching whether the seller has held the property for five years or more and thus whether the seller's effective rate of tax may be nine percent rather than 10 percent. As accurate estimates might be crucial to submitting a winning offer for qualifying property, the qualifying conservation organization, in principle, would need to have information about the financial affairs of the seller. Such an offer strategy is a more information intensive process than typical real estate transactions.

The proposal would impose an additional paperwork and record-keeping burden on the qualifying conservation organization and the selling taxpayer. The qualifying conservation organization must provide certification to the taxpayer selling the property that the sale and purchase is a qualifying conservation transaction. The selling taxpayer must retain this certification in order to claim the exclusion. Presumably a separate reporting requirement would be established for the buyer and or seller to notify the Internal Revenue Service of a qualifying sale. As the holding period of potentially qualifying property is satisfied by reference to the taxpayer's family, rather than solely by reference to the taxpayer's ownership of the property, in some cases documentation from other persons also would be required. In practice, the proposal also may require that a qualifying purchasing conservation organization offer a seller some sort of indemnification to protect the seller from a subsequent transfer of the property that would not satisfy the conservation qualifications of the proposal

Prior Action

An identical proposal was included in the President's fiscal year 2002 budget proposal.

I. Energy Provisions

1. Extend and modify the tax credit for producing electricity from certain sources

Prior and Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit was 1.7 cents per kilowatt hour for 2001. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

Subsequent to the submission of the President's budget to Congress, P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," extended each of the placed in service dates by two years, i.e., the credit applies for otherwise qualifying facilities placed in service before January 1, 2004.

Description of Proposal

The proposal would extend the placed in service date for facilities that produce electricity from wind and closed-loop biomass to include electricity from those facilities placed in service before January 1, 2005. The proposal would not extend the placed in service date for facilities that produce electricity from poultry waste.

The proposal would expand the set of qualifying facilities to include facilities that produce electricity from qualifying open-loop biomass and open-loop biomass or closed-loop biomass co-fired with coal. For these purposes open-loop biomass would be defined as any solid, nonhazardous, cellulosic waste material that is segregated from other waste materials is derived from:

(1) any of the following forest-related resources: mill residues, pre-commercial thinnings, slash and brush, but not including old growth timber or wood waste incidental to pulp and paper production;

(2) waste pallets, crates, and dunnage, and landscape or right-of-way tree trimmings, but not including unsegregated municipal solid waste (garbage) and post-consumer waste paper;

(3) agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop byproducts or residues.

Qualifying open-loop facilities would be any facility placed in service before January 1, 2005. In the case of facilities placed in service before January 1, 2002, taxpayers would be eligible for credit for production from January 1, 2002 through December 31, 2004 (rather than ten years of production from the date the facility was placed in service) and the credit would be equal to 60 percent of the otherwise allowable credit.

In the case of open-loop or closed-loop biomass co-fired with coal, qualifying facilities would be any facility placed in service before January 1, 2005. Taxpayers producing electricity from such facilities would only be eligible to claim credit for electricity produced from January 1, 2002 though December 31, 2004 (rather than ten years of production from the date the facility was placed in service) and the credit would be at a rate equal to 30 percent of the otherwise allowable credit, regardless of the amount of open-loop or closed-loop biomass fuel burned with the coal.

The proposal also would permit a lessee to claim the credit rather than the owner of any qualified facility for leases entered into after the date of enactment. Lastly, the proposal would modify the current limitation on the credit allowable for projects financed with tax-exempt financing such that the credit claimed by a taxpayer is reduced by an amount equal to the value of the tax exemption.

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

See the general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

The Energy Policy Act of 1992 created section 45 as a production credit for electricity produced from wind and closed-loop biomass for production from certain facilities placed in service before July 1, 1999. The Ticket to Work and Work Incentives Improvement Act of 1999 added poultry waste as a qualifying energy source, extended the placed in service date through December 31, 2001, and made certain modifications to the requirements of qualifying wind facilities. The President's fiscal year 2001 and 2002 budgets proposed extending and expanding the categories of facilities that would qualify for the production credit under section 45. A similar provision was included in Division C of H.R, 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and S. 1979, the "Energy Tax Incentives Act of 2002," as reported by the Senate Finance Committee (S. Rep. No. 107-140, 2002).

2. Tax credit for residential solar energy systems

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law personal tax credit for residential fuel cell, solar or wind energy property.

Description of Proposal

The proposal would provide a tax credit for the purchase of rooftop photovoltaic systems and solar water heating systems for use in a dwelling unit that is used by the taxpayer as a residence. Equipment would qualify for the credit only if is used exclusively for purposes other than heating swimming pools. The credit would be equal to 15 percent of qualified investment up to a cumulative maximum of $2,000 for solar water heating systems and $2,000 for rooftop photovoltaic systems. This credit would be nonrefundable. For businesses, this credit would be subject to the limitations of the general business credit and the basis of the qualified property would be reduced by the amount of the credit claimed. Taxpayers must choose between the proposed credit and the present tax credit for each investment.

Effective date.--The credit would apply to equipment placed in service after December 31, 2001 and before January 1, 2006 for solar water heating systems and after December 31, 2001 and before January 1, 2008 for rooftop photovoltaic systems.

Analysis of Complexity and Policy Issues

See the general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

An identical proposal was contained in the President's fiscal year 2002 budget proposal. A similar proposal was contained in the President's 1999, 2000, and 2001 budget proposals, and similar provisions are contained in Division C of H.R. 4, "The Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and S. 1979, the "Energy Tax Incentive Act of 2002," as reported by the Senate Finance Committee (S. Rep. No. 107-140, 2002).

3. Provide tax credit for purchase of certain hybrid and fuel cell vehicles

Prior and Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004. For the current year, taxpayers may claim a credit equal to 75 percent of the otherwise allowable amount (*i.e.*, effectively a 7.5-percent credit with a maximum of $3,000). There is no carry forward or carry back of the credit for electric vehicles.

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels

(natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction for clean-fuel vehicles phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004. For the current year, taxpayers may deduct 75 percent of the otherwise allowable amount.

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. Expensing for clean-fuel vehicle refueling property is unavailable for expenditures after December 31, 2004.

Subsequent to the President's submission of the budget to Congress, P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," deferred the phase down of the credit for the purchase of electric vehicles for two years. Taxpayers may claim the full amount of the credit for qualified purchased made in 2002 and 2003. The phase down of the credit value commences in 2004 and the credit is unavailable for purchased after December 31, 2006. Likewise, the Job Creation and Worker Assistance Act of 2002 deferred the deduction for clean-fuel vehicle property by two years. Taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in 2002 and 2003. The phase down of the deduction for clean-fuel vehicles commences in 2004 and the deduction is unavailable for purchases after December 31, 2006. The Job Creation and Worker Assistance Act of 2002 also extended the placed in service date for clean-fuel vehicle refueling property by two years. The deduction for clean-fuel vehicle refueling property is available for property placed in service prior to January 1, 2007.

Description of Proposal

In general

The proposal would provide a tax credit for the purchase of a qualified hybrid vehicle or fuel cell vehicle purchased after December 31, 2001 and before January 1, 2008. The credits would be available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers would be able to claim only one of the credits per vehicle and taxpayers who claim either credit would not be able to claim the qualified electric vehicle credit or the deduction for clean-fuel vehicles for the same vehicle. For business taxpayers the credit would be part of the general business credit and the taxpayer would reduce his or her basis in the vehicle by the amount of the credit. A qualifying vehicle must meet all applicable regulatory requirements for safety and air pollutants.

Hybrid vehicles

A qualifying hybrid vehicle would be a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both and internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). The amount of credit for the purchase of a hybrid vehicle would be the sum of two components, a base credit amount that varies with the amount of power available from the rechargeable storage system and a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2000 model year standard.

Table 4, below, shows the proposed base credit amounts.

Table 4--Hybrid Vehicle Base Credit Amount Dependent Upon the Power Available from the Rechargeable Energy Storage System As a Percentage of the Vehicles Maximum Available Power

Base Credit Amount	If Rechargeable Energy Storages System Provides:	
	at least	**but less than**
$250	5% of maximum available power	10% of maximum available power
$500	10% of maximum available power	20% of maximum available power
$750	20% of maximum available power	30% of maximum available power
$1,000	30% of maximum available power	

For these purposes, a vehicle's power available from its rechargeable energy storage system as a percentage of maximum available power would be calculated as the maximum value available from the battery or other energy storage device during a standard power test, divided by the sum of the battery or other energy storage device and the SAE net power of the heat engine.

Table 5, below, shows the proposed additional fuel economy credit available to hybrid vehicles whose fuel economy exceeds that of a base fuel economy. For these purposes the base fuel economy would be the 2000 model year city fuel economy rating for vehicles of various weight classes (see below).

Table 5--Additional Fuel Economy Credit for Hybrid Vehicles

Credit	If Fuel Economy of the Hybrid Vehicle Is:	
	at least	but less than
$500	125% of base fuel economy	150% of base fuel economy
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	

Fuel cell vehicles

A qualifying fuel cell vehicle would be a motor vehicle that is propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle and may or may not require reformation prior to use. The amount of credit for the purchase of a fuel cell vehicle would be determined by the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy would be the 2000 model year city fuel economy rating for vehicles of various weight classes (see below). Table 6, below, shows the proposed credits for qualifying fuel cell vehicles.

Table 6--Credit for Qualifying Fuel Cell Vehicles

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	at least	But less than
$1,000	150% of base fuel economy	175% of base fuel economy
$1,500	175% of base fuel economy	200% of base fuel economy
$2,000	200% of base fuel economy	225% of base fuel economy
$2,500	225% of base fuel economy	250% of base fuel economy
$3,000	250% of base fuel economy	275% of base fuel economy
$3,500	275% of base fuel economy	300% of base fuel economy
$4,000	300% of base fuel economy	

Base fuel economy

The base fuel economy would be the 2000 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" would be that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 7, below, shows the 2000 model year city fuel economy for vehicles by type and by inertia weight class.

Table 7--2000 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	43.7	37.6
1,750	43.7	37.6
2,000	38.3	33.7
2,250	34.1	30.6
2,500	30.7	28.0
2,750	27.9	25.9
3,000	25.6	24.1
3,500	22.0	21.3
4,000	19.3	19.0
4,500	17.2	17.3
5,000	15.5	15.8
5,500	14.1	14.6
6,000	12.9	13.6
6,500	11.9	12.8
7,000	11.1	12.0
8,500	11.1	12.0

Effective date.--The proposal would be effective for vehicles purchased after December 31, 2001.

Analysis of Complexity and Policy Issues

See the general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

Code sections 30 and 179A were enacted as part of the Energy Policy Act of 1992.

The President's fiscal year 1999, 2000, 2001, and 2002 budget proposals proposed creating a credit for electric and hybrid vehicles.

Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, would extend section 179A, would extend and modify section 30, and would provide new credits for the purchase of alternative fuel vehicles, hybrid vehicles, fuel cell motor vehicles, and advanced lean burn technology vehicles.

4. Provide tax credit for energy produced from landfill gas

Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (section 29). For the year 2000, the inflation adjusted value of the credit was $6.14 per barrel or oil or barrel equivalent (*e.g.*, $1.09 per thousand cubic feet of natural gas[99]). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Landfill gas qualifies for the section 29 production credit as gas produced from biomass.

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of non-conventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

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[99] Conversion made assuming 1,027 Btu per cubic foot of natural gas, the conversion factor reported for dry gas in production by the Energy Information Administration, U.S. Department of Energy, *Monthly Energy Review*, February 2001.

Description of Proposal

The proposal would extend the section 29 production credit for landfill gas if the gas is produced from a facility placed in service after December 31, 2001 and before January 1, 2011, and is sold (or used to make electricity) before January 1, 2011. In the case of a landfill that was placed in service before January 1, 2002, the proposal would provide that the term "facility" included the wells, pipes, and related components used to collect landfill methane and that production of gas attributable to wells, pipes, and related components placed in service after December 31, 2001 is treated as produced from the portion of the facility placed in service after that date.

In the case of gas produced at landfills subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines, the taxpayer would be permitted a credit equal to two-thirds of the otherwise allowable credit (1) beginning with gas produced on and after January 1, 2008 in the case of a landfill on which any portion of a facility for producing gas at that landfill was placed in service before July 1, 1998, or (2) beginning with gas produced on and after January 1, 2002 in all other cases.

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

See the general discussion following the description of the proposed tax credit for combined heat and power property, below.

Prior Action

Section 29 was enacted (originally as Code section 44D) in the Crude Oil Windfall Profit Tax of 1980, effective for fuels produced and sold after December 31, 1979 and before January 1, 2001, from facilities placed in service after December 31, 1979 and before January 1, 1990. The Technical and Miscellaneous Revenue act of 1988 extended the placed in service date by one year. The Omnibus Budget Reconciliation Act of 1990 extended the placed in service date through 1992 and provided for credit for qualifying fuels through 2002. The Energy Policy Act of 1992 provided that facilities that produce gas from biomass or synthetic fuels from coal would be deemed to be placed in service before 1993 if they were placed in service before 1997 pursuant to a binding contract in effect prior to 1996. The Small Business Job Protection Act of 1996 extended the binding contract and placed in service dates for facilities producing synthetic fuel from coal and gas from biomass.

The President's fiscal year 2001 and 2002 budgets proposed adding landfill gas to the electricity production credit under section 45.

Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, would permit landfill gas from facilities placed in service after June 30, 1998 and before January 1, 2007 to claim credit for production for five years at a credit rate of $3.00 (indexed) per barrel equivalent ($2.00 in 2002 in the case of gas from a landfill subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines).

5. Tax credit for combined heat and power property

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

Description of Proposal

The proposal would provide a 10 percent credit for the purchase of combined heat and power property.

CHP property would mean property: (1) which uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) which has an electrical capacity of more than 50 kilowatts or a mechanical energy capacity of more than 67 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) which produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent (70 percent in the case of a system with an electrical capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower, or an equivalent combination of electrical and mechanical capacities).

CHP property would not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

If a taxpayer is allowed a credit for CHP property, and the property would ordinarily have a depreciation class life of 15 years or less, the depreciation period for the property is treated as having a 22-year class life. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to combined heat and power property may be carried back before the effective date of this provision.

Effective date.--The credit would apply to equipment placed in service after December 31, 2001 and before January 1, 2007.

Analysis of Complexity and Policy Issues

See the general discussion immediately below.

Prior Action

A similar proposal was contained in the President's fiscal year 2000 budget proposal. Identical provisions are contained in Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and S. 1979, the "Energy Tax Incentive Act of 2002," as reported by the Senate Finance Committee (S. Rep. No. 107-140, 2002).

Analysis of Complexity and Policy Issues for 1. - 5.

General rationale for tax benefits for energy conservation and pollution abatement

The general rationale for providing tax benefits to energy conservation and pollution abatement is that there exist externalities in the consumption or production of certain goods. An externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole. When the social costs of consumption exceed the private costs of consumption, a negative externality exists. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over-consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under consumption or production of the good producing the positive externality. The reason for the over consumption or under consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption or production, because in this case private costs and benefits will be equal to social costs and benefits.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, there are two possible government interventions that could produce a more socially desirable level of pollution. One such approach would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that

represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. An alternative approach would be to employ a system of payments, such as perhaps tax credits, to essentially pay polluters to reduce pollution. If the payments can be set in such a way as to yield the right amount of reduction (that is, without paying for reduction more than the reduction is valued, or failing to pay for a reduction where the payment would be less than the value of the pollution reduction), the socially desirable level of pollution will result. The basic difference between these two approaches is a question of who pays for the pollution reduction. The tax approach suggests that the right to clean air is paramount to the right to pollute, as polluters would bear the social costs of their pollution. The alternative approach suggests that the pollution reduction costs should be borne by those who receive the benefit of the reduction.

In the case of a positive externality, the appropriate economic policy would be to impose a negative tax (i.e. a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production.

Targeted investment tax credits

Three of the proposals related to energy and the environment (residential solar, combined heat and power, hybrid vehicles) are targeted investment tax credits designed to encourage investment in certain assets that reduce the consumption of conventional fuels and that reduce the emissions of gases related to atmospheric warming and other pollutants. The following general analysis of targeted investment tax credits is applicable to these proposals.

As a general matter of economic efficiency, tax credits designed to influence investment choices should be used only when it is acknowledged that market-based pricing signals have led to a lower level of investment in a good than would be socially optimal. In general, this can occur in a market-based economy when private investors do not capture the full value of an investment--that is, when there are positive externalities to the investment that accrue to third parties who did not bear any of the costs of the investments. For example, if an individual or corporation can borrow funds at 10 percent and make an investment that will return 15 percent, they will generally make that investment. However, if the return were 15 percent, but only eight percent of that return went to the investor, and seven percent to third parties, the investment will generally not take place, even though the social return (the sum of the return to the investor and other parties) would indicate that the investment should be made. In such a situation, it may be desirable to subsidize the return to the investor through tax credits or other mechanisms in order that the investor's return is sufficient to cause the socially desirable investment to be made. In this example, a credit that raised the return to the investor to at least 10 percent would be necessary. Even if the cost of the credit led to tax increases for the third parties, they would presumably be better off since they enjoy a 7-percent return from the investment, and the credit would only need to raise the return to the investor by two percent for him or her to break even. Thus, even if the third parties would bear the full cost of the credit, they would, on net, enjoy a 5-percent return to the investment (7 percent less two percent).

There are certain aspects of targeted tax credits that could impair the efficiency with which they achieve the desired goal of reduced atmospheric emissions. By targeting only certain investments, other more cost-effective means of pollution reduction may be overlooked. Many economists would argue that the most efficient means of addressing pollution would be through a direct tax on the pollution-causing activities, rather than through the indirect approach of targeted tax credits for certain technologies. By this approach, the establishment of the economically efficient prices on pollutants, through taxes, would result in the socially optimal level of pollution. This would indirectly lead to the adoption of the types of technologies favored in the President's budget, but only if they were in fact the most socially efficient technologies. In many cases, however, establishing the right prices on pollution-causing activities through taxes could be administratively infeasible, and other solutions such as targeted credits may be more appropriate.

A second potential inefficiency of investment tax credits is one of budgetary inefficiency, in the sense that their budgetary costs could be large relative to the incremental investment in the targeted activities. The reason for this is that there will generally have been investment in the activities eligible for the credit even in the absence of the credit. Thus, for example, if investors planned to invest a million dollars in an activity before a 10-percent credit, and the credit caused the investment to rise $100,000 to $1.1 million because of the credit, then only $100,000 in additional investment can be attributed to the credit. However, all $1.1 million in investments will be eligible for the 10-percent credit, at a budgetary cost of $110,000 (10 percent of 1.1 million). Thus, only $100,000 in additional investment would be undertaken, at a budgetary cost of $110,000. Because there is a large aggregate amount of investment undertaken without general investment credits, introducing a general credit would subsidize much activity that would have taken place anyway.

Targeted credits like the above proposals, on the other hand, are likely to be more cost effective, from a budget perspective, in achieving the objective of increased investment, if only for the reason that a government would likely not consider their use if there were already extensive investment in a given area. Thus, not much investment that would take place anyhow is subsidized, because there presumably is not much of such investment taking place. The presumption behind these targeted tax credits is that there is not sufficient investment in the targeted areas because the alternative and more emissions-producing investments are less costly to the investor. Hence, a tax credit would be necessary to reduce costs and encourage investment in the favored activity.

A final limitation on the efficiency of the proposed credits is their restricted availability. The proposed tax credits come with several limitations beyond their stipulated dollar limitation. Specifically, they are nonrefundable and cannot be used to offset tax liability determined under the AMT.[100] The credit for solar equipment has a cap on the dollar amount of the credit, and thus after the cap is reached the marginal cost of further investment becomes equal to the market price again, which is presumed to be inefficient. The impact of these limitations is to make the

[100] The AMT treatment of the proposed personal credits for residential solar and hybrid vehicles is unclear. The proposals do not state that the credits would be allowed to offset AMT liability.

credit less valuable to those without sufficient tax liability to claim the full credit, for those subject to the AMT, or those who have reached any cap on the credit. Given the arguments outlined above as to the rationale for targeted tax credits, it is not economically efficient to limit their availability based on the tax status of a possible user of the credit. It can be argued that, if such social benefits exist and are best achieved through the tax system, the credit should be both refundable and available to AMT taxpayers. Some would argue that making the credits refundable may introduce compliance problems that would exceed the benefits from encouraging the targeted activities for the populations lacking sufficient tax liability to make use of the credit. With respect to the AMT, the rationale for the limitation is to protect the objective of the AMT, which is to insure that all taxpayers pay a minimum (determined by the AMT) amount of tax. Two differing policy goals thus come in conflict in this instance. Similarly, caps on the aggregate amount of a credit that a taxpayer may claim are presumably designed to limit the credit's use out of some sense of fairness, but again, this conflicts with the goal of pollution reduction.

A justification for targeted tax credits that has been offered with respect to some pollution abatement activities, such as home improvements that would produce energy savings (installation of energy saving light bulbs or attic insulation, for example), is that the investment is economically sound at unsubsidized prices, but that homeowners or business owners are unaware of the high returns to the investments. The argument for targeted tax credits in this case is that they are needed to raise the awareness of the homeowner, or to lower the price sufficiently to convince the homeowner that the investment is worthwhile, even though the investment is in their interest even without the subsidy. These arguments have been called into question recently on the grounds that the returns to the investments have been overstated by manufacturers, or are achievable only under ideal circumstances. This view holds that the returns to these investments are not dissimilar to other investments of similar risk profile, and that homeowners have not been economically irrational in their willingness to undertake certain energy saving investments. Of course, to the extent that there are negative externalities from the private energy consumption, these households, though making rational private choices, will not make the most socially beneficial choices without some form of subsidy.

A final justification offered for targeted tax credits in some instances is to “jump start” demand in certain infant industries in the hopes that over time the price of such goods will fall as the rewards from competition and scale economies in production are reaped. However, there is no guarantee that the infant industry would ultimately become viable without continued subsidies. This argument is often offered for production of electric cars--that if the demand is sufficient the production costs will fall enough to make them ultimately viable without subsidies. This justification is consistent with the current proposals in that the credits are available only for a limited period of time.

Production tax credits

Two of the proposals related to energy and the environment (the wind and biomass tax credit and the credit for landfill gas) are production tax credits. These credits differ from investment tax credits in that the credit amount is based on production, rather than on investment. Some argue that a production credit provides for a stream of tax benefits, rather than an up-front lump sum, and that the stream of benefits can help provide financing for investment projects that would use wind or biomass facilities. On the other hand, an up-front tax credit

provides more certainty, as the future production credits could possibly be curtailed by future Congresses. In general, investors prefer certainty to uncertainty, and thus may discount the value of future production credits. Another difference between a production credit and an investment credit is that the latter provides only a temporary distortion to the market--once the investment is made, normal competitive market conditions will prevail and the rational firm will only produce its end product if it can cover its variable costs. With a production credit, a firm may actually profitably produce even though it cannot cover its variable costs in the absence of the credit. This would generally be considered an economically inefficient outcome unless there are positive externalities to the production of the good that exceed the value of the credit. In the case of electricity produced from wind or biomass, if it is presumed that the electricity produced from these sources substitutes for electricity produced from the burning of fossil fuels, economic efficiency will be improved so long as the credit does not have to be set so high in order to encourage the alternative production that it exceeds the value of the positive externality. On the other hand, by making some production of electricity cheaper, it is possible that the credit could encourage more electricity consumption. On net, however, there would be less electricity produced from fossil fuels.

The proposed structure of these two credits raises an additional question of efficiency. The proposed credit for landfill gas would base the credit on the energy value of the gas recovered. While gas can be used directly as a fuel, in practice, much landfill gas is burned on, or near, site to make electricity. The value of the proposed credit for landfill gas can be compared to the credit for electricity produced from wind and closed-loop biomass facilities. As noted above, efficiency is enhanced if the value of the credit does not exceed the positive externality that the alternative source of electricity produces. From this logic, if the value of the credit per kilowatt-hour of electricity produced exceeds that of a properly set (i.e., efficiency maximizing) credit provided to electricity produced from wind or closed-loop biomass, efficiency can only be enhanced if the positive externalities from generating electricity from landfill gas exceed the positive externalities from generating electricity from wind or closed-loop biomass. The value of the present-law section 29 credit expressed in terms of credit dollars per kilowatt-hour of electricity produced from landfill gas depends upon the efficiency of the combustion facility that burns the gas to make electricity. In 2000, if the combustion facility was 20 percent efficient, the value of the section 29 credit for landfill gas when converted to electricity was 1.8 cents per kilowatt-hour. For a combustion facility that was 30 percent efficient, the value of the section 29 credit for landfill gas when converted to electricity was 1.2 cents per kilowatt-hour.[101] In 2000, the value of the section 45 production credit for wind and closed-loop biomass facilities was 1.7 cents per kilowatt-hour.

With respect to the expansion of the biomass materials eligible for the credit, the basic issues are the same as those outlined above for any tax benefit for energy conservation or pollution abatement. To justify the credit on economic grounds, the positive externalities from

[101] In 2000, the section 29 credit was $6.14 per barrel of oil equivalent. A barrel of oil has a heat value of 5.8 million British thermal units (Btu). One kilowatt-hour of electricity has a heat value of 3,142 Btu. If a gas combustion facility is 20 percent efficient, it requires five Btu of gas to produce one Btu of electricity. The Department of Energy reports that landfill gas facilities that produce electricity generally are less than 30 percent efficient.

the burning of biomass for the production of electricity must outweigh the costs of the tax subsidy. With respect to the waste materials that are proposed to be made eligible for the credit, one positive externality is similar to that of wind power production, namely the reduction in electricity production from the more environmentally damaging coal. Another consideration with the waste products is whether their current disposal is harmful to the environment. If so, an additional positive externality may exist from discouraging such disposal. If the disposal is harmful to the environment and is a partial justification for the credit, then ideally the credit amount should vary for each biomass waste product if their present disposal varies in its harm to the environment. A single credit rate would be justified if the negative externalities are of a similar magnitude, or if administrative considerations would make multiple credit rates problematic.

With respect to the special lower credits for non-closed-loop biomass facilities that are already placed in service and for biomass co-fired with coal, additional justifications for the credits need to be offered. In general, establishing a credit for existing economic activity is inefficient--if the activity already takes place without the credit then establishing the credit only produces a windfall gain for the producers. Establishing the credit for the existing activity would only be efficient if the existing plants would otherwise choose to shut down if the credit were not established, and the cost of the credit was less than the value of the positive external benefits that result from the continued operation of the plant. In the case of the special credit rate for co-firing biomass with coal, establishing the credit for existing facilities that already co-fire would need to meet the same tests for the credit to be efficient and not merely produce windfall gains. To the extent that the credit encourages coal burning facilities to begin to co-fire with biomass, the credit with respect to such co-firing could be efficient to the extent that the positive external benefits from the co-firing exceed the costs of the credit. If it is impractical to separate new co-firing from existing investments in co-firing, then for the credit to be economically efficient the external gains from the newly induced co-firing would need to exceed the costs of the credit with respect to the new co-firing as well as the cost of the credit with respect to any windfall gains to facilities that would co-fire in the absence of the credit.

Complexity issues

Each of the President's proposals in the area of energy production and conservation can be expected to increase the complexity of tax law. Though the effect of each provision, or even all provisions collectively, on tax law complexity may be small, they would all add to complexity merely by providing new tax benefits not previously available. Taxpayers considering using these provisions would need to consider the impact of additional tax factors in making investment decisions, and taxpayers that actually utilize the provisions will need to educate themselves as to the rules of the provisions, as well as fill out the necessary forms to claim the tax benefits. Taxpayers constrained by the AMT or by the nonrefundability of the credit would face additional complications in determining the value of the various credits to them, which would further complicate their investment choices.

In general, the production tax credits add less complexity in the aggregate as there are relatively few taxpayers in a position to claim such benefits. The personal credits, such as those for solar equipment and hybrid vehicles, add more aggregate complexity as many more taxpayers

will avail themselves of the credit and they could induce millions more to at least consider purchasing hybrid vehicles or solar equipment as a result of the credit.

6. Income tax credit and partial excise tax exemption for certain renewable fuels

In general

Ethanol and methanol derived from renewable sources (e.g., biomass) are eligible for an income tax credit (the "alcohol fuels credit") equal under present law to 53 cents per gallon (ethanol) and 60 cents per gallon (methanol). These tax credits are provided to blenders of the alcohol with other taxable fuels, or to retail sellers of unblended alcohol fuels. Typically, ethanol is blended with gasoline subject to Highway Trust Fund excise tax to produce "gasohol." The 53-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2003 through 2007. The credit is scheduled to expire after December 31, 2007.

The alcohol fuels tax credit may be claimed either against income tax or as a reduction in Federal excise tax as a reduction in excise tax imposed on gasoline or other highway motor fuels. Most of the benefit of the alcohol fuels credit is claimed through the excise tax system.

Small producer credit

In addition to the general alcohol fuels credit, small producers of ethanol are entitled to a 10-cents-per-gallon income tax credit. Eligible small producers are defined as persons whose production capacity does not exceed 30 million gallons and whose annual production does not exceed 15 million gallons. This credit is scheduled to expire after December 31, 2007.

Description of Proposal

The President's budget proposal would extend the present-law income tax credits and excise tax reduced rates for ethanol fuels and ethanol-blended fuels ("gasohol") for an additional three years, through December 31, 2010. The amount of the credit/rate reductions would be reduced as scheduled under present law in 2003 and 2005. Also, as under present law, no credit or rate reduction would be available during any period when the Highway Trust Fund fuel excise taxes are limited to 4.3 cents per gallon or less.

Analysis of Complexity and Policy Issues

Policy issues

The present-law tax credit for the production of ethanol is 53 cents per gallon of pure ethanol produced. Ethanol's price averaged approximately $1.40 per gallon in 2001 in the United States. The present-law tax subsidy is 38 percent of the market price. Proponents of such subsidies for ethanol state that the present-law tax credit helps advance several policy goals. As a motor fuel, ethanol displaces petroleum in the market place. To the extent that the petroleum displaced is imported petroleum, the production of ethanol improves the United States' energy security. In addition, by displacing imported petroleum, the production of ethanol may reduce the U.S. trade deficit. Moreover, ethanol is an oxygenate in motor fuels that is environmentally friendly, reducing urban smog.

Proponents also note that production of ethanol for motor fuel creates an important source of demand for corn. Corn used to produce ethanol comprises approximately five percent of domestic corn production. In the absence of the tax subsidy, demand for corn will fall. This would reduce corn and soybean prices and, thereby, farm incomes. With falling farm prices, jobs in farming and related industries, such as farm equipment manufacturing, would be lost.

Opponents of the tax credit for ethanol observe that ethanol's impact in the domestic motor fuels market is modest. Ethanol production totaled approximately 1.8 billion gallons in 2001. By comparison, the United States, on net, imported approximately 462 million gallons of petroleum and petroleum products per day in 2001. Total motor gasoline produced and imported into the United States in 2001 totaled approximately 134 billion gallons. Opponents note that in the market for motor fuels, ethanol displaces high cost petroleum first. Imported petroleum is not necessarily the high cost petroleum to a refiner. Consequently, ethanol may displace domestic petroleum and that claims of an improved trade balance and energy independence may be overstated.

Opponents argue that to the extent the tax subsidy increases the market price for corn, consumers at large are hurt as higher corn prices increase the price of milk, beef, pork, and poultry. They claim that the effects on the price of corn and soybeans are likely to be smaller in the long run than in the short run. They note that these grains are traded in the world market and in the absence of the subsidy the corn might be exported, thereby sustaining farm incomes and jobs in farming and related industries. In 1998 and 1999, the United States exported approximately 20 percent of corn produced and approximately 30 percent of soybean production.[102] Opponents also note increased regulatory preference for ethanol as an oxygenate to meet air quality standards. They observe that such air quality regulations should produce increased demand for ethanol in the market and question whether further subsidy at current levels is warranted if other forces are creating an increase in demand.

Complexity issues

As described above, the benefit of the alcohol fuels income tax credit may be claimed through reduced excise tax paid on alcohol blended with gasoline. While claiming the benefit through the excise tax system provides a timing advantage, it adds complexity to the excise tax system. Gasoline excise taxes are imposed upon removal of the gasoline from a registered terminal facility. Registered owners of record inside the terminal are liable for the gasoline excise tax and include it in the price charged to persons removing the fuel from the terminal. Ethanol blenders typically are wholesale distributors who remove the gasoline and pay the tax-inclusive price to their supplier. If the ethanol blenders are registered with the Internal Revenue Service ("IRS"), the tax component of the price typically is lower; if the blenders are not registered or the fuel is removed pursuant to a terminal exchange agreement between suppliers, the full amount of the tax is due. In the latter case, an expedited refund is available to blenders. Possible uncertainty as to a blender's status and administrative issues associated with the expedited refunds are sources of complexity in the excise tax system resulting from the alcohol fuels credit provisions.

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[102] United States Department of Agriculture, *Crop Production*.

Additionally, ETBE, an ether produced using ethanol, may be blended by refiners before gasoline leaves the refinery for a terminal. Because gasoline from many sources is commingled during pipeline transport, the regular alcohol component requirements for claiming the benefit through the excise tax system may not be satisfied. For such cases, the IRS has prescribed special "election" and deposit rules for refiners to allow them to capture the benefit of the income tax credit through the excise tax system. These rules further increase complexity.

Prior Action

The alcohol fuels tax provisions (credit and excise tax rate reduction) were last extended and modified in 1998 as part of the Transportation Equity For the 21st Century Act. That act authorized Highway Trust Fund expenditures for the period through September 3, 2003.

7. Tax treatment of nuclear decommissioning funds

Present Law

Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act"), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a "qualified fund") is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[103]

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the "cost of service

[103] As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

requirement").[104] Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant's estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the "ruling amount"). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[105] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[106]

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[107] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund's owner as it is earned.

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[104] Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

[105] Treas. Reg. sec. 1.468A-6.

[106] Treas. Reg. sec. 1.468A-6(f).

[107] These funds are generally referred to as "nonqualified funds."

Description of Proposal

Repeal of cost of service requirement

The proposal would repeal the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified fund.

Exception to ruling amount for certain decommissioning costs

The proposal also would permit taxpayers to make contributions to a qualified fund in excess of the maximum annual contribution amount (IRS ruling amount) up to an amount that equals the present value of the amount required to fund the nuclear powerplant's pre-1984 decommissioning costs to which the qualified fund relates. Any amount transferred to the qualified fund that has not previously been deducted or excluded from gross income would be allowed as a deduction over the remaining useful life of the nuclear powerplant. If a qualified fund that has received amounts under this rule is transferred to another person, that person will be entitled to the deduction at the same time and in the same manner as the transferor. Thus, if the transferor was not subject to tax at the time and thus would have been unable to use the deduction, the transferee will similarly not be able to utilize the deduction. Amounts contributed (and the earnings on such amounts) under these rules would not be taken into account in determining the ruling amount for the qualified fund.

Clarify treatment of transfers of qualified funds and deductibility of decommissioning costs

The proposal would clarify the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established. In addition, the proposal would provide that all nuclear decommissioning costs are deductible when paid.

Contributions to a qualified fund after useful life of powerplant

The proposal also would allow deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments would be permitted to the extent they do not cause the assets of the qualified fund to exceed the present value of the taxpayer's allocable share (current or former) of the nuclear decommissioning costs of such nuclear powerplant.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2001.

Analysis of Complexity and Policy Issues

Policy issues

The cost of service limitation on the amount of deductible contributions to a qualified nuclear decommissioning fund reflects the regulatory environment that existed when the

legislation was originally enacted in 1984 and all taxable entities producing nuclear power were subject to rate regulation. More recently, the process of deregulating the electric power industry has begun at both the Federal and state level. Proponents of the proposal argue that the present-law limitation is outdated, and that the rules relating to deductible contributions to nuclear decommissioning funds should be modernized to reflect industry deregulation.

The process of deregulation takes different forms in different jurisdictions. A jurisdiction may choose to eliminate rate regulation and allow rates to be set by the market instead of the public utility commission. Although such market rates may include an element compensating a generator of nuclear power for its anticipated decommissioning costs, there is no regulatory cost of service amount against which to measure a deductible contribution. A line charge or other fee could be imposed by a State or local government or a public utility commission to ensure that adequate funds will be available for decommissioning, but there is no assurance that this will be the case. The taxpayer generating the electricity may not be the same as the taxpayer distributing it. In those cases, the use of line charges and other customer based fees as a vehicle to satisfy the requirement that deductible contributions not exceed cost of service may not be successful.

The exception allowing a taxpayer responsible for nuclear power plant decommissioning to deduct contributions to a qualified nuclear decommissioning fund for future payment costs was enacted in Congress' belief that the establishment of segregated reserve funds for paying future nuclear decommissioning costs was of national importance.[108] In a deregulated future, the continued deduction of such contributions may be prevented unless the cost of service limitation is repealed. The loss of deductibility may reduce the amount of funds available for decommissioning in the future.

In addition, the proposal would allow taxpayers to transfer to a qualified fund decommissioning costs for the period prior to the qualified fund's existence (generally pre-1984 decommissioning costs of a nuclear powerplant). Proponents of this aspect of the proposal argue that it would provide equal treatment to all decommissioning costs and would provide an incentive for taxpayers to ensure that sufficient funds are being reserved for decommissioning costs. However, some may argue that safeguards are already in place that require funds to be available for decommissioning and that this aspect of the proposal merely reduces the effective tax rate on earnings associated with the reserved funds. Finally, clarifying the treatment of transfers of qualified funds would remove a tax barrier that may be hindering taxpayers from fulfilling various policy goals of electricity deregulation.

Complexity issues

The many aspects of the proposal would provide clarification to issues that would simplify the administration of the present-law provision and likely reduce the cost of complying with the tax law and minimize disputes between taxpayers and the IRS.

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[108] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, p. 270.

Prior Action

An identical proposal was included in the President's fiscal year 2002 budget proposal. A similar provision was included in Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001. The cost of service provision and the clarifications of the treatment of transfers and deductibility of decommissioning costs were included in S. 1979, the "Energy Tax Incentives Act of 2002," as reported by the Senate Finance Committee (S. Rep. No. 107-140, 2002).

III. TAX ADMINISTRATION PROVISIONS

A. IRS Restructuring and Reform Act of 1998

1. Modify section 1203 of the IRS Restructuring and Reform Act of 1998

Present Law

Section 1203 of the IRS Restructuring and Reform Act of 1998 requires the IRS to terminate an employee for certain proven violations committed by the employee in connection with the performance of official duties. The violations include: (1) willful failure to obtain the required approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets; (2) providing a false statement under oath material to a matter involving a taxpayer; (3) with respect to a taxpayer, taxpayer representative, or other IRS employee, the violation of any right under the U.S. Constitution, or any civil right established under titles VI or VII of the Civil Rights Act of 1964, title IX of the Educational Amendments of 1972, the Age Discrimination in Employment Act of 1967, the Age Discrimination Act of 1975, sections 501 or 504 of the Rehabilitation Act of 1973 and title I of the Americans with Disabilities Act of 1990; (4) falsifying or destroying documents to conceal mistakes made by any employee with respect to a matter involving a taxpayer or a taxpayer representative; (5) assault or battery on a taxpayer or other IRS employee, but only if there is a criminal conviction or a final judgment by a court in a civil case, with respect to the assault or battery; (6) violations of the Internal Revenue Code, Treasury Regulations, or policies of the IRS (including the Internal Revenue Manual) for the purpose of retaliating or harassing a taxpayer or other IRS employee; (7) willful misuse of section 6103 for the purpose of concealing data from a Congressional inquiry; (8) willful failure to file any tax return required under the Code on or before the due date (including extensions) unless failure is due to reasonable cause; (9) willful understatement of Federal tax liability, unless such understatement is due to reasonable cause; and (10) threatening to audit a taxpayer for the purpose of extracting personal gain or benefit.

Section 1203 also provides non-delegable authority to the Commissioner to determine that mitigating factors exist, that, in the Commissioner's sole discretion, mitigate against terminating the employee. The Commissioner, in his sole discretion, may establish a procedure to determine whether an individual should be referred for such a determination by the Commissioner.

Description of Proposal

The proposal would remove (1) the late filing of refund returns and (2) employee versus employees acts from the list of violations requiring termination. The proposal would also add unauthorized inspection of returns and return information to the list of violations. Additionally, the proposal would require the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by section 1203 of the IRS Restructuring and Reform Act of 1998. The Commissioner would retain the non-delegable authority to determine whether mitigating factors support a personnel action other than that specified in the guidelines for a covered violation.

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

Policy issues

Late filing of refund returns

The proposal would have the effect of treating IRS employees more like individuals employed by any other employer, with respect to late filing of refund returns. Late filing generally is not grounds for termination by most employers. In addition, late filing of refund claims is generally not subject to penalty under the Code.[109] Proponents of the proposal relating to late filings would argue that late filings of refund claims is not the type of serious conduct for which the severe penalties imposed by the IRS Restructuring and Reform Act should apply. Others may argue that IRS employees, as the enforcers of the country's tax laws, should be held to a higher standard and be required to timely file all income tax returns.

Employee vs. employee allegation

Advocates of removing employee versus employee allegations from the list of grounds for IRS employee termination would argue that allegations of willful conduct by IRS employees against other IRS employees can be addressed by existing administrative and statutory procedures. Other means, such as the Whistleblower Protection Act, negotiated grievance processes, and civil rights laws, exist to address employee complaints and appeals. Moreover, it is argued that under present-law rules, parallel investigative and adjudicative functions for addressing employee complaints and appeals are confusing to employees and burdensome for the IRS.

Proponents also believe that it is appropriate to remove employee versus employee allegations from the list of section 1203 violations because, unlike other section 1203 violations, such allegations do not violate taxpayer protections. On the other hand, opponents would point out that Congress believed it appropriate to include such allegations in the statutory list of grounds for IRS employee termination. They would argue that including employee versus employee allegations in the section 1203 violation list benefits tax administration. Another issue to consider is the extent to which the inclusion of employee versus employee allegations on the list of section 1203 violations deters inappropriate behavior (by reducing the likelihood of real employee versus employee actions) or increases inappropriate behavior (by the inappropriate use of allegations to intimidate other employees).

Unauthorized inspection of returns

Advocates of the proposal argue that unauthorized inspection of tax returns and return information is a serious act of misconduct that should be included in the list of violations subject to termination, as unauthorized inspection is as serious as the other taxpayer rights protections covered by section 1203. Code section 7213A already makes the unauthorized inspection of returns and return information illegal, with violations punishable by fine, imprisonment, and

[109] The refund claim must be filed prior to the expiration of the applicable statute of limitations for the taxpayer to receive the refund.

discharge from employment. Even though unauthorized inspection is punishable under a separate law, it is argued that extending section 1203 coverage to unauthorized inspection will strengthen the IRS' power to discipline without the penalty being overturned.

On the other hand, opponents of this part of the proposal would point out that most violations of Code section 7213A are not prosecuted, but employees are subject to discipline based on administrative determination. The IRS policy has been to propose termination of employment in cases of unauthorized inspection, but in a number of recent cases, arbitrators and the Merit Systems Protection Board have overturned the IRS' determination to terminate employees for such violations.

Advocates would also argue that adding unauthorized inspection of returns to the list of section 1203 violations will prevent overturning of the IRS' determination of the level of appropriate employee punishment. Some might question whether it is appropriate to use an internal administrative process to achieve a result that the IRS states that it has been unable to achieve through judicial or external administrative processes. In addition, adding unauthorized inspection of returns to the list of section 1203 violations could add to the fear of IRS employees that they will be subject to unfounded allegations and lose their jobs as a result, which might deter fair enforcement of the tax laws.

The position taken by the IRS with respect to this part of the proposal could be criticized as inconsistent with its position on the employee versus employee allegations piece of the proposal. The IRS argues that employee versus employee allegations should be removed from the list of section 1203 violations because such allegations can be addressed by existing administrative and statutory procedures, while at the same time argues that unauthorized inspection of returns should be added to the list of violations even though it is punishable under a separate law. Some might view these positions as inconsistent.

While the proposal makes unauthorized inspection (which is a misdemeanor) a section 1203 violation, it does not make unauthorized disclosure (which is a felony under Code section 7213) a section 1203 violation. Arguably, more damage could be done by disclosing sensitive tax information to a third party than by looking at a return out of curiosity. Thus, the proposal could be criticized as lacking the proper focus.

Penalty guidelines

Some are concerned that the IRS' ability to administer the tax laws efficiently is hampered by a fear among employees that they will be subject to false allegations and possibly lose their jobs. Proponents of the proposal requiring the IRS to publish detailed guidelines argue that these guidelines are needed to provide notice to IRS employees of the most likely punishment that will result from specific violations. They believe that the certainty provided by specific guidelines would improve IRS employee morale and enhance the fundamental fairness of the statute.

Others argue that since Congress intended for the section 1203 violations to warrant termination, it is not appropriate to allow the IRS to determine a lesser level of punishment. Additionally, they argue that the claim that penalty guidelines are necessary is inconsistent with

the proposal to remove from the list the two violations that are said to most often warrant punishment other than that required under section 1203 (late filed refund returns and employee versus employee allegations).

Complexity issues

The proposal has elements that may both increase and decrease complexity. The IRS must review and investigate every allegation of a section 1203 violation. Removing late filing of refund returns and employee versus employee allegations from the list of section 1203 violations may make it easier for the IRS to administer section 1203, as there would be fewer types of allegations that would require section 1203 review and investigation. Similarly, adding unauthorized inspection of returns to the list of violations may complicate IRS administration, as there would likely be an increase in the number of 1203 violations requiring IRS review and investigation. Additionally, because unauthorized inspection of returns violations under Code section 7213A are currently subject to disciple based on administrative determination by the IRS, adding such violations to the list of section 1203 violations would require the IRS to change current practice and follow section 1203 procedures instead.

Additional penalty guidelines may also either increase or decrease complexity. Additional guidelines may increase complexity by creating more rules for the IRS to establish and follow. The guidelines would also have to be periodically updated to ensure that punishments for specific violations continue to be appropriate. On the other hand, additional penalty guidelines may decrease complexity by providing clarity as to specific punishments for specific employee violations, which may enhance the IRS' effectiveness in administering section 1203.

Prior Action

No prior action.[110]

2. Modifications with respect to frivolous returns and submissions

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[111] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

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[110] The original provisions were enacted in the IRS Restructuring and Reform Act of 1998. There has been no other prior action.

[111] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

Description of Proposal

The proposal would modify this IRS-imposed penalty by increasing the amount of the penalty to $5,000.

The proposal would also modify present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision would apply would be requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal would permit the IRS to dismiss such requests. Second, the proposal would permit the IRS to impose a penalty of $5,000 for repeat behavior or failing to withdraw the request after being given an opportunity to do so.

The proposal would permit the IRS to maintain records of frivolous submissions by taxpayers.[112] The proposal would also require that this designation be removed after a reasonable period of time if the taxpayer makes no further frivolous submissions to the IRS.

The proposal would require the IRS to publish (at least annually) a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

Effective date.--The proposal would be effective for submissions filed after the date of enactment.

Analysis of Complexity and Policy Issues

In general

Genuinely frivolous returns and submissions raise arguments that have been repeatedly rejected by the courts. Dealing with genuinely frivolous returns and submissions consumes resources at the IRS and in the courts that can better be utilized in resolving legitimate disputes with taxpayers. Accordingly, the proposals may improve the overall functioning of the tax system and improve the level of service provided to taxpayers who not raise these frivolous arguments.

It may be beneficial to implement separately the portion of the proposal relating to the Taxpayer Advocate. This would permit the Taxpayer Advocate to tailor the dismissal and penalty procedures so as to best integrate them with its existing procedures. It may also be beneficial for the Taxpayer Advocate to have formal input into the development of the published list of frivolous positions.

Some may question why this IRS-imposed penalty should be applied only to individuals instead of applying it to all taxpayers who raise frivolous arguments. Expanding the scope of the

[112] It is unclear how this portion of the proposal is intended to interact with the statutory prohibition on the designation of taxpayers by the IRS as "illegal tax protesters (or any similar designation)" (sec. 3707 of the Internal Revenue Service Restructuring and Reform Act of 1998; P.L. 105-206 (July 22, 1998)).

penalty to cover all taxpayers would treat similarly situated taxpayers who raise identical arguments in the same manner, which would promote fairness in the tax system. Similarly, some may question why this penalty should apply only to income tax returns and not to all other types of returns, such as employment tax and excise tax returns. Applying this penalty to all taxpayers and all types of tax returns would make this IRS-imposed penalty more parallel to the Tax Court penalty, where these constraints do not apply. In addition, applying this IRS-imposed penalty to all taxpayers and to all types of returns would make this proposal more parallel to the Administration's proposal to treat certain fraudulent claims and returns as nullities; that proposal applies to all taxpayers and to all types of returns.

Complexity issues

Increasing the amount of an existing penalty arguably would have no impact on tax law complexity. It could be argued that the procedural changes made by the proposal, taken as a whole, would simplify tax administration by speeding the disposition of frivolous submissions, despite the fact that some elements of the proposals (such as the requirement to publish a list of frivolous positions) may entail increased administrative burdens.

Prior Action

No prior action.

3. Authorize IRS to enter into installment agreements that provide for partial payment

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.[113]

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

Description of Proposal

The proposal would clarify that the IRS is authorized to enter into installment agreements with taxpayers who do not provide for full payment of the taxpayer's liability over the life of the agreement.

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[113] Sec. 6331(k).

Effective date.--The proposal would be effective for installment agreements entered into on or after the date of enactment.

Analysis of Complexity and Policy Issues

In general

Partial payment installment agreements may be beneficial to taxpayers and the government by encouraging taxpayers to pay at least a portion of their tax liability. Partial payment installment agreements may also be detrimental to the interests of the government if they permit taxpayers who have the ability to pay their liability in full to pay in part. It is difficult to assess the relative benefits and detriments of the proposal because insufficient detail has been specified.

The proposal does not specify what is to become of the unpaid balance remaining at the conclusion of the partial payment installment agreement. If the unpaid balance is treated like other tax debts under IRS' current administrative practices, little of it may be collected because at that point in time it will be older than many other tax debts in IRS' collection inventory, which reduces its relative level of prioritization for collection activity. In addition, relatively little time may remain in the statute of limitations[114] at the conclusion of the partial payment installment agreement, which also could reduce the opportunities for collection activity. This means that in practical terms, taxpayers may be able to achieve the same results as if they had entered into an offer in compromise via a partial payment installment agreement.

The statutory mechanism by which the government and the taxpayer agree to reduce the amount of tax liability of a taxpayer is an offer in compromise.[115] An offer may be made on the basis of doubt as to collectibility, doubt as to liability, or because of other factors such as equity, hardship, or public policy; most are entered because of doubt as to collectibility. It is unclear how the proposal will interact with the offer in compromise provision of present law. For example, to apply for an offer in compromise, a taxpayer must provide detailed financial information. The proposal does not specify whether similar detailed financial information must be provided prior to acceptance of a partial payment installment agreement. Paralleling those requirements would minimize opportunities by taxpayers to pay an amount that is less than they have the ability to pay. More generally, it is unclear whether the proposal would cause a significant reduction in the number of taxpayers who enter into offers in compromise. If the application process for a partial payment installment agreement is less rigorous than that applicable to offers in compromise, taxpayers may prefer to apply for a partial payment installment agreement to achieve the same effect: a reduction in the total amount of tax they will have to pay. The proposal also does not specify whether IRS would be required to review partial payment installment agreements periodically (such as every two years), to determine whether the taxpayer has new or additional resources that would permit increased payments (or full

[114] In general, enforced collection actions must commence within 10 years after assessment of the tax (sec. 6502(a)).

[115] Sec. 7122.

immediate payment of the balance). Such a requirement could increase the total amount collected under the proposal.

The proposal does not specify how it interacts with the provision of present law that requires the IRS to enter into an installment agreement with taxpayers who meet specified criteria.[116] Although it might be possible to apply this automatic installment agreement provision to partial payment installment agreements, the more appropriate policy result might be to restrict automatic installment agreements to those where the liability is to be paid in full. The proposal also does not specify how it interacts with the related proposal permitting termination of installment agreements if the taxpayer fails to file tax returns or make required deposits. The more appropriate policy result might be to terminate a partial payment installment agreement in the same circumstances under which any other installment agreement is terminated.

Complexity issues

Permitting partial payment installment agreements may lead to an increase in the overall number of installment agreements. It could be argued that this increases complexity in tax administration because of increased record-keeping on the part of both taxpayers and the IRS. Further record-keeping would also be required with respect to the balance of taxes due not included in the partial payment installment agreement and with respect to any defaults by the taxpayer. On the other hand, it could be argued that that provision causes no increase in complexity because administrative mechanisms are already in place for the collection of tax liability both under an installment agreement and without such an agreement. Further, if partial payment installment agreements result in a reduction in other types of collection actions, the net result could be an improvement in the efficiency of tax collection.

Prior Action

No prior action.

4. Termination of installment agreements

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only[117] if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails

[116] Sec. 6159(c).

[117] Sec. 6159(b)(1).

to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate or incomplete information when applying for an installment agreement; (5) there has been a significant change in the financial condition of the taxpayer; or (6) the collection of the tax is in jeopardy.[118]

Description of Proposal

The proposal would grant the IRS authority to terminate an installment agreement when a taxpayer fails to timely make a required Federal tax deposit[119] or fails to timely file a tax return (including extensions). The termination could occur even if the taxpayer remained current with payments under the installment agreement.

Effective date.--The proposal would be effective for failures occurring on or after the date of enactment.

Analysis of Complexity and Policy Issues

The proposal may lead to some additional complexity in the administration of installment agreements. For example, taxpayers might not understand why their installment agreement is being terminated, leading to additional phone calls to the IRS. In addition, the proposal would require that additional explanatory information be provided to taxpayers, which will increase complexity. It might be possible to reduce this increase in complexity by implementing these termination procedures in a manner as parallel as possible to the similar termination procedures for offers in compromise. It may also be beneficial to permit the reinstatement of terminated installment agreements for reasonable cause, parallel to the procedures applicable to offers in compromise.

The proposal reflects the policy determination that taxpayers who are permitted to pay their tax obligations through an installment agreement should also be required to remain current with their other Federal tax obligations. Some might be concerned that this does not take into account the benefits of making continued installment payments. A key benefit to the government of continued installment payments is that the government continues to receive payments, whereas if the installment agreement is terminated payments stop. Some might note that termination of the installment agreement permits the IRS to begin immediate collection actions, such as instating liens and levies, which could increase government receipts. In the past several years, however, there has been a significant decline in IRS' enforced collection activities, so that others might respond that terminating installment agreements might not lead to increased receipts to the government, in that the cessation of receipts due to termination of installment agreements may outweigh increases in receipts through additional enforcement activities.

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[118] Sec. 6159(b)(2), (3), and (4).

[119] Failure to timely make a required Federal tax deposit is not considered to be a failure to pay any other tax liability at the time such liability is due under section 6159(b)(4)(B) because liability for tax generally does not accrue until the end of the taxable period, and deposits are required to be made prior to that date (sec. 6302).

The proposal would be effective for failures occurring on or after the date of enactment. Some may question whether it is fair to taxpayers who are currently in an installment agreement to terminate those agreements.

Prior Action

No prior action.

5. Consolidate review of collection due process cases in the Tax Court

Present Law

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property (sec. 6330(a)). Similar rules apply with respect to liens (sec. 6320). The hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. That appeal must be brought to the United States Tax Court, unless the Tax Court does not have jurisdiction over the underlying tax liability. If that is the case, then the appeal must be brought in the district court of the United States (sec. 6330(d)). Special rules apply if the taxpayer files the appeal in the incorrect court.

The United States Tax Court is established under Article I of the United States Constitution[120] and is a court of limited jurisdiction.[121]

Description of Proposal

The proposal would consolidate all judicial review of these collection due process determinations in the United States Tax Court.

Effective date.--The proposal would apply to appeals filed after the date of enactment.

Analysis of Complexity and Policy Issues

Because the Tax Court is a court of limited jurisdiction, it does not have jurisdiction over all of the taxes (such as, for example, most excise taxes) that could be at issue in collection due process cases. The judicial appeals structure of present law was designed in recognition of these jurisdictional limitations; all appeals must be brought in the Tax Court unless that court does not have jurisdiction over the underlying tax liability. Accordingly, the proposal would give the Tax Court jurisdiction over issues arising from a collection due process hearing, while the Tax Court will not have jurisdiction over an identical issue arising in a different context.

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[120] Sec. 7441.

[121] Sec. 7442.

The proposal would provide simplification benefits to taxpayers and to the IRS by requiring that all appeals be brought in the Tax Court, because doing so will eliminate confusion over which court is the proper venue for an appeal and will significantly reduce the period of time before judicial review.[122]

Some believe that present law "entitles a taxpayer patently seeking delay to achieve his goal by refiling in the District Court."[123] The proposal would provide simplification benefits by eliminating this opportunity for delay.

Prior Action

The right to a hearing and judicial review of the determinations made at these hearings were enacted in the IRS Restructuring and Reform Act of 1998.[124]

6. Office of Chief Counsel review of offers-in-compromise

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Amounts of $50,000 or more can only be accepted if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel (sec. 7122).

Description of Proposal

The proposal would repeal the requirement that an offer-in-compromise of $50,000 or more must be supported by a written opinion from the Office of Chief Counsel. Written opinions would only be provided if the Secretary determines that an opinion is required with respect to a compromise.

Effective date.--The proposal would apply to offers-in-compromise submitted or pending on or after the date of enactment.

Analysis of Complexity and Policy Issues

Repealing the requirement that an offer-in-compromise of $50,000 or more be supported by a written opinion from the Office of Chief Counsel will simplify the administration of the

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[122] This reduction is attributable to the elimination of time periods built into the judicial review process to permit the refiling of appeals that have been filed with the wrong court.

[123] *Nestor v. Commissioner*, 118 T.C. No. 10 (February 19, 2002), concurring opinion by Judge Beghe.

[124] Sec. 3401(b) of P.L. 105-206 (July 22, 1998).

offer-in-compromise provisions by the IRS. Repealing this requirement also would increase the level of discretionary authority that the IRS may exercise, which may lead to increasingly inconsistent results among similarly situated taxpayers. Some may believe that Chief Counsel review is appropriate for all offers-in-compromise above specified dollar thresholds, similar to the review of large refund cases by the Joint Committee on Taxation.[125]

Prior Action

The $50,000 threshold was raised from $500 in 1996.[126]

[125] Sec. 6405. The threshold for Joint Committee review is currently $2 million.

[126] Sec. 503 of the Taxpayer Bill of Rights 2 (P.L. 104-168; July 30, 1996).

B. Other Provisions

1. Permit IRS to use certificate of mailing instead of certified or registered mail

Present Law

The Code requires the IRS to mail a variety of notices to taxpayers. Some of these notices are statutorily required to be sent via certified or registered mail.[127]

Description of Proposal

The proposal would permit the IRS to use a certificate of mailing instead of certified or registered mail for most notices now requiring certified or registered mail.

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

The requirement that notices be sent via certified or registered mail has benefits for both the IRS and for taxpayers. The benefit to the IRS is that it has readily available proof that the taxpayer actually received the notice. The cost of this to the IRS is both in the extra time required to be expended by its personnel in following certified or registered mail procedures and in the extra postage costs. Some believe that the benefit to the taxpayer is that certified or registered mail may commonly connote the importance of the contents being mailed and may help assure that the taxpayer actually received the notice. Others believe that the use of certified or registered mail does not necessarily help assure that the taxpayer actually received the notice (as compared with an ordinary first class mailing). Although actual receipt of the notice is in fact not statutorily required in most instances, actual receipt is generally beneficial to both the taxpayer and the IRS. In the view of some observers, these benefits could be eliminated in cases in which a certificate of mailing could be used under the proposal. However, the certificate of mailing may be a simpler process that minimizes both the cost of postage to the IRS and the time expended by IRS personnel, thus providing a tax administration simplification benefit.

The proposal does not specify which notices would use a certificate of mailing and which would continue to require certified or registered mail. Accordingly, it is difficult to analyze the impact of the proposal in the context of specific notices.

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[127] The following provisions of the Code require that IRS send notices by certified or registered mail: 534(b), 982(c)(1), 2011(c)(3), 2058(b)(2)(C)(i), 6015(e)(1)(A)(i)(I), 6038A(e)(2)(C), 6038C(d)(2)(C), 6110(f)(3)(B) and (f)(4)(B), 6164(d)(2), 6212 (a) and (b)(2), 6234(a), 6245(b)(1), 6320(a)(2)(C), 6330(a)(2)(C), 6331(d)(2)(C), 6532 (a)(1) and (a)(4) and (c)(2), 7428(b)(3), 7430(f)(2), 7436(b)(2), 7476(b)(5), 7477(b)(3), 7478(b)(3), and 7479(b)(3). The following provision of the Code requires that States send notices by certified or registered mail: 6402(e)(4)(A). The following provisions of the Code require that taxpayers send information to the IRS by certified or registered mail: 527(j)(2)(A)(II) and 7425(c)(1) and (3).

Prior Action

No prior action.

2. Repeal the return receipt requirement for pre-levy notices of hearing rights

Present Law

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property (sec. 6330(a)). This notice must be either given in person, left at the dwelling or usual place of business, or sent by certified or registered mail (return receipt requested) to that person's last known address (sec. 6330(b)).

Description of Proposal

The proposal would eliminate the return-receipt requirement for these notices. The proposal would still require that they be sent by certified or registered mail.

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

The return receipt requirement has benefits for both the IRS and for taxpayers. The benefit to the IRS is that the IRS has readily available proof that the taxpayer actually received the notice. The cost of this to the IRS is both in the extra time required to be expended by its personnel in following return receipt procedures and in the extra postage costs. The benefit to the taxpayer is that it helps assure that the taxpayer actually received the notice. Although actual receipt of the notice is in fact not statutorily required in most instances, actual receipt is generally beneficial to both the taxpayer and the IRS. Because the notices would still be required to be sent by certified or registered mail, arguably the proposal would achieve no significant simplification benefit.

Prior Action

The right to a hearing and the requirement of notice to the taxpayer of this right were enacted in the IRS Restructuring and Reform Act of 1998.[128]

3. Repeal the requirement that IRS provide separate notices to married filers living at the same address

Present Law

The IRS is required by statute to send any notice relating to a joint return separately to each individual filing the joint return, wherever practicable.[129]

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[128] Sec. 3401(b) of P.L. 105-206 (July 22, 1998).

Description of Proposal

The proposal would repeal this statutory requirement. The proposal would not affect any other requirement that notices relating to a joint return be sent separately to each individual filing the joint return, such as where the individuals have established separate residences.[130]

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

The impact that the proposal will have on taxpayers depends in part on the state of their marriage. In some instances, taxpayers are still married and living at the same address, but are in the process of separating or getting divorced. If that process is adversarial or accompanied by hostility, it is possible that one spouse will not inform the other spouse of the content of mail that is addressed to the two jointly. The statutory requirement of separately mailed notices was designed to increase the likelihood of both spouses in fact receiving actual notice. Accordingly, some might view the proposal as diluting the rights of taxpayers by decreasing the likelihood of both spouses receiving actual notice in precisely the circumstances (impending dissolution of the marriage) where actual notice may be most beneficial. On the other hand, other taxpayers are happily married, living at the same address, and communicate with each other fully. Sending separate notices to taxpayers in this situation is needlessly duplicative and can confuse them. Repealing this statutory requirement will eliminate this type of duplicative notice and will reduce the administrative costs of the IRS. Thus, the proposal would achieve (at best) a limited reduction in the complexity of tax administration, but at a cost of decreasing the likelihood of both spouses receiving actual notice.

As a modification of the proposal, some might consider it beneficial to retain the separate notice requirement for the most important notices (such as deficiency notices), while repealing it for other notices.

Prior Action

No prior action.

4. Treat certain fraudulent claims and returns as nullities

Present Law

In some instances, the amount of tax an individual reports as due on the individual's tax return is less than the correct amount of tax. Some of these discrepancies may be evident on the face of the return itself (such as a mathematical error) while others may not become evident until later (such as after an IRS audit). These discrepancies are, in general, handled under one of two

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[129] Section 3201(d) of the IRS Restructuring and Reform Act of 1998 (P.L. 105-206; July 22, 1998).

[130] Sec. 6212(b)(2).

different sets of procedural rules. The first set of rules is applicable to mathematical and computational errors (generally called the "math error" rules) (sec. 6213(b)(1)). These rules apply to a relatively narrow, explicitly enumerated type of errors and allow the IRS to correct these errors rapidly and provide very limited opportunity to challenge the determination of the IRS. In recent years, these procedures have been extended to the earned income credit. The second set of rules relate to deficiencies (sec. 6211). These rules apply to all discrepancies other than those to which the math error rules apply and they afford the taxpayer many opportunities to challenge the determination of the IRS.

Description of Proposal

The proposal would apply the math error rules (instead of the deficiency rules) to fraudulent claims for the following: the EIC, gasoline or special fuels, the RIC credit, and the REIT credit. The proposal would also apply the math error rules (instead of the deficiency rules) to persons who forge a signature in order to obtain a refund of tax in another person's name.

Effective date.--The proposal would be effective for fraudulent claims submitted after the date of enactment.

Analysis of Complexity and Policy Issues

Dealing with fraudulent claims consumes resources at the IRS that can better be utilized in resolving legitimate disputes with taxpayers. Accordingly, the proposal may improve the overall functioning of the tax system and improve the level of service provided to taxpayers who do not make these fraudulent claims. In this respect, the proposal would provide a simplification benefit.

The proposal does not provide a definition of what will be considered fraudulent. Such a definition may be significant because of the summary nature of the math error process.

Prior Action

No prior action.

5. Extend the due date for electronically filed tax returns

Present Law

In general, individuals must file their income tax returns and pay the full amount owed by April 15 (sec. 6072(a)). This deadline applies regardless of the method the taxpayer may choose to submit the tax return to the IRS. The Secretary may grant reasonable extensions of time for filing returns, but in general the time for paying tax may not be extended (sec. 6081(a)). Failure to file or pay on a timely basis may subject the taxpayer to interest and penalties.

Description of Proposal

The proposal would extend the due date for filing and paying individual income taxes to April 30 provided that the taxpayer files the return electronically and pays the entire balance due

electronically by that date. The due date for filing by any other method or for filing electronically but paying the balance due by non-electronic means would not be changed.

Effective date.--The proposal would be effective for returns filed after December 31, 2002.

Analysis of Complexity and Policy Issues

In general, the proposal would reduce the administrative burdens on the IRS by encouraging more taxpayers to file and pay electronically. In particular, extending the date by which payment must be made could provide encouragement to file electronically to a significant number of filers of balance due returns, some of which are very complex. The proposal is, however, unlikely to cause a substantial increase in electronic filing for returns due a refund (which already constitute the vast majority of electronically filed returns) because one of the primary reasons those taxpayers file electronically is to receive their refunds more rapidly; a further extension of time to file contravenes that reason. The proposal would also reduce the administrative burdens on individual taxpayers to the extent that they prepare the tax return electronically and that doing so is less of a burden on them by encouraging those individuals to file their returns electronically (instead of preparing their returns electronically but submitting them to the IRS on paper). The proposal would, in addition, encourage return preparers to file electronically, in that it will give the preparers additional time to prepare the returns.

Because taxpayers must both file and pay electronically in order to receive the benefit of the proposed extension of time, the proposal might increase the administrative burdens on some individuals in that currently the only electronic mechanism[131] for paying the balance due with the return is paying by credit card.[132] Credit card providers charge a convenience fee[133] in addition to the amount of tax due, which may deter some individuals from paying the balance due electronically.

Although the proposal may in many instances reduce administrative burdens, having two different filing deadlines could be considered to increase complexity. It would, for example, require explaining two filing deadlines, which is likely to be more complex than explaining one. Another factor that could affect complexity is the whether all tax forms (or only some tax forms) will be eligible for electronic filing by the time the proposal becomes effective. For the current

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[131] It is possible that the IRS' EFTPS electronic payment system, now used almost entirely by business taxpayers to deposit payroll taxes, could accommodate individuals paying a balance due on their individual income tax returns. Although a small number of individual taxpayers now participate in EFTPS, this payment mechanism is not discussed as an option in general IRS publications describing electronic filing.

[132] As an alternative, taxpayers could increase their wage withholding or estimated tax payments so as not to owe a balance due with the return.

[133] The fee generally amounts to several percent of the total amount of taxes charged.

tax filing season, many (but not all) tax forms are eligible for electronic filing.[134] If some forms cannot be filed electronically, taxpayers required to file those forms will be ineligible for this extension of time to file and pay. This could mean that taxpayers with especially complicated returns will be ineligible for this extension. If taxpayers are unaware in advance of their ineligibility to file electronically, ineligible taxpayers (erroneously believing they were eligible) might delay the filing of their returns until after April 15 intending to take advantage of this extension of time, then discover they are in fact ineligible and consequently inadvertently file late returns (owing interest and penalties). Some taxpayers could also find themselves inadvertently filing late returns if they planned to take advantage of the proposal but their computers break down after April 15 and they are unable to make them operational prior to April 30.

Prior Action

No prior action.

[134] See IRS Publication 1345A, Filing Season Supplement for Authorized IRS e-file Providers, pp.23-4.

IV. REFORM UNEMPLOYMENT COMPENSATION

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the net Federal unemployment tax rate 0.8 percent. Because all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. The net Federal unemployment tax revenue finances the administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. Also, additional distributions ("Reed Act distributions") may be made to the States, if the balance of the Federal unemployment trust funds exceeds certain statutory ceilings. The States use Reed Act distributions to finance their regular State programs (which are mainly funded with State unemployment taxes) and the other half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax has been extended through 2007.

Description of Proposal

The proposal would repeal the temporary FUTA surtax in 2003. It would further reduce the gross FUTA tax rate to 5.6 percent in 2007.

Apart from tax provisions, the responsibility for the program's administrative funding would be transferred solely to the States as part of a comprehensive reform of the unemployment compensation program. During the transition to greater State financing, larger administrative grants and special Reed Act distributions will be provided to the States.

Effective date.--The provision generally would be effective for labor performed on or after January 1, 2003.

Analysis of Complexity and Policy Issues

Complexity issues

The reduction of the FUTA rate likely would not affect tax law complexity to any significant degree. Generally, the application of a tax rate is a not a complicated element of a tax. The resulting reduction in revenues would likely not have a significant impact on the complexity of tax administration, but rather, would relate to administration of the unemployment compensation program.

Policy issues

The 0.2 percent FUTA surtax repeal and the gross rate reduction under the proposal would have the effect of reducing the FUTA tax collected by the Federal government. This reduction would have a social policy impact, reducing the funds available for administration of the unemployment system. Whether this reduction is viewed as desirable or undesirable would depend on social policy considerations relating to the merits, or lack thereof, of the current unemployment system. As a matter of tax policy, however, it could be argued, on the one hand, that earmarking revenues for a particular use (administering the unemployment system) tends to increase the cost, and reduce the efficiency, of tax law administration; while on the other hand, earmarking revenues has the benefit of identifying the funds devoted to that purpose.

Prior Action

No prior action.

V. EXPIRING PROVISIONS

A. Two-Year Extensions

1. Extend the work opportunity tax credit

Prior and Present Law

In general

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

Targeted groups eligible for the credit

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

Subsequent to the submission of the President's budget to Congress, the credit was extended for two years by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002" (for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2004).

Description of Proposal

The proposal would extend the work opportunity tax credit through December 31, 2003.

Effective date.--The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

Analysis of Complexity and Policy Issues

Complexity issues

Extension of the provision for two years provides some continuity and simplifies tax planning during that period for taxpayers and practitioners. Some may argue that a permanent extension would have a greater stabilizing effect on the tax law. They point out that temporary expirations, like the current one, not only complicate tax planning but also deter some taxpayers from participating in the program. Others who are skeptical of the efficacy of the WOTC program may argue that not extending the credit could eliminate a windfall benefit to certain taxpayers and permanently reduce complexity in the Code.

Overview of policy issues

The WOTC is intended to increase the employment and earnings of targeted group members. The credit is made available to employers as an incentive to hire members of the targeted groups. To the extent the value of the credit is passed on from employers to employees, the wages of target group employees will be higher than they would be in the absence of the credit.[135]

The rationale for the WOTC is that employers will not hire certain individuals without a subsidy, because either the individuals are stigmatized (e.g., convicted felons) or the current productivity of the individuals is below the prevailing wage rate. Where particular groups of individuals suffer reduced evaluations of work potential due to membership in one of the targeted groups, the credit may provide employers with a monetary offset for the lower perceived work potential. In these cases, employers may be encouraged to hire individuals from the targeted groups, and then make an evaluation of the individual's work potential in the context of the work environment, rather than from the job application. Where the current productivity of individuals is currently below the prevailing wage rate, on-the-job-training may provide individuals with skills that will enhance their productivity. In these situations, the WOTC provides employers with a monetary incentive to bear the costs of training members of targeted groups and providing them with job-related skills which may increase the chances of these individuals being hired in unsubsidized jobs. Both situations encourage employment of members of the targeted groups, and may act to increase wages for those hired as a result of the credit.

As discussed below, the evidence is mixed on whether the rationales for the credit are supported by economic data. The information presented is intended to provide a structured way to determine if employers and employees respond to the existence of the credit in the desired manner.

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[135] For individuals with productivity to employers lower than the minimum wage, the credit may result in these individuals being hired and paid the minimum wage. For these cases, it would be clear that the credit resulted in the worker receiving a higher wage than would have been received in the absence of the credit (e.g., zero).

Efficiency of the credit

The credit provides employers with a subsidy for hiring members of targeted groups. For example, assume that a worker eligible for the credit is paid an hourly wage of w and works 2,000 hours during the year. The worker is eligible for the full credit (40 percent of the first $6,000 of wages), and the firm will receive a $2,400 credit against its income taxes and reduce its deduction for wages by $2,400. Assuming the firm faces the full 35-percent corporate income tax rate, the cost of hiring the credit-eligible worker is lower than the cost of hiring a credit-ineligible worker for 2,000 hours at the same hourly wage w by 2,400 (1-.35) = $1,560.[136] This $1,560 amount would be constant for all workers unless the wage (w) changed in response to whether or not the individual was a member of a targeted group. If the wage rate does not change in response to credit eligibility, the WOTC subsidy is larger in percentage terms for lower wage workers. If w rises in response to the credit, it is uncertain how much of the subsidy remains with the employer, and therefore the size of the WOTC subsidy to employers is uncertain.

To the extent the WOTC subsidy flows through to the workers eligible for the credit in the form of higher wages, the incentive for eligible individuals to enter the paid labor market may increase. Since many members of the targeted groups receive governmental assistance (e.g., Temporary Assistance for Needy Families or food stamps), and these benefits are phased out as income increases, these individuals potentially face a very high marginal tax rate on additional earnings. Increased wages resulting from the WOTC may be viewed as a partial offset to these high marginal tax rates. In addition, it may be the case that even if the credit has little effect on observed wages, credit-eligible individuals may have increased earnings due to increased employment.

The structure of the WOTC (the 40-percent credit rate for the first $6,000 of qualified wages) appears to lend itself to the potential of employers churning employees who are eligible for the credit. This could be accomplished by firing employees after they earn $6,000 in wages and replacing them with other WOTC-eligible employees. If training costs are high relative to the size of the credit, it may not be in the interest of an employer to churn such employees in order to maximize the amount of credit claimed. Empirical research in this area has not found an explicit connection between employee turnover and utilization of WOTC's predecessor, the Targeted Jobs Tax Credit ("TJTC").[137]

Job creation

The number of jobs created by the WOTC is certainly less than the number of certifications. To the extent employers substitute WOTC-eligible individuals for other potential

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[136] The after-tax cost of hiring this credit eligible worker would be ((2,000)(w)-2,400)(1-.35) dollars. This example does not include the costs to the employer for payroll taxes (e.g., Social security, Medicare and unemployment taxes) and any applicable fringe benefits.

[137] See, for example, Macro Systems, Inc., *Final Report of the Effect of the Targeted Jobs Tax Credit Program on Employers*, U.S. Department of Labor, 1986.

workers, there is no net increase in jobs created. This could be viewed as merely a shift in employment opportunities from one group to another. However, this substitution of credit-eligible workers for others may not be socially undesirable. For example, it might be considered an acceptable trade-off for a targeted group member to displace a secondary earner from a well-to-do family (e.g., a spouse or student working part-time).

In addition, windfall gains to employers or employees may accrue when the WOTC is received for workers that the firm would have hired even in the absence of the credit. When windfall gains are received, no additional employment has been generated by the credit. Empirical research on the employment gains from the TJTC has indicated that only a small portion of the TJTC-eligible population found employment because of the program. One study indicates that net new job creation was between five and 30 percent of the total certifications. This finding is consistent with some additional employment as a result of the TJTC program, but with considerable uncertainty as to the exact magnitude.[138]

A necessary condition for the credit to be an effective employment incentive is that firms incorporate WOTC eligibility into their hiring decisions. This could be done by determining credit eligibility for each potential employee or by making a concerted effort to hire individuals from segments of the population likely to include members of targeted groups. Studies examining this issue through the TJTC found that some employers made such efforts, while other employers did little to determine eligibility for the TJTC prior to the decision to hire an individual.[139] In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

Prior Action

A similar proposal was included in the President's fiscal year 2001 budget proposal.[140]

2. Extend the welfare-to-work tax credit

Prior and Present Law

In general

The welfare-to-work tax credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the

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[138] Macro Systems, Inc., Impact Study of the Implementation and Use of the Targeted Jobs Tax Credit: Overview and Summary, U.S. Department of Labor, 1986.

[139] For example, see U.S. General Accounting Office, Targeted Jobs Tax Credit: Employer Actions to Recruit, Hire, and Retain Eligible Workers Vary (GAO-HRD 91-33), February 1991.

[140] P.L. 107-147, "The Job Creation and Worker Assistance Act of 2002," extended the credit for two years.

first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within two years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer's deduction for wages is reduced by the amount of the credit.

Expiration date

Subsequent to the submission of the President's budget to Congress, the credit was extended for two years by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002" (for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2004).

Description of Proposal

The proposal would extend the welfare to work credit for two years (through December 31, 2003).

Effective date.--The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

Analysis of Complexity and Policy Issues

Complexity issues

The expiration of the credit has complicated tax planning for affected taxpayers by creating uncertainty. The temporary extension eliminates that uncertainty for a two-year period. Some argue, however, either the permanent expiration of the credit or the permanent extension of the credit would provide reduced uncertainty permanently. Preference between these latter two alternatives would correlate to perceived efficacy of the welfare-to-work credit generally.

If both the welfare-to-work credit and work opportunity credit were extended, then simplification could be achieved by combining the two credits. Such a combination would eliminate dual certification and filing requirements. It would also reduce tax law complexity by eliminating the need for two separate but similar sets of rules for the two credits.

Policy issues

Proponents of the credit argue that extension of the welfare-to-work tax credit encourages employers to hire, train, and provide certain benefits and more permanent employment, to longer-term welfare recipients. Opponents argue that tax credits to employers for hiring certain classes of individuals do not increase overall employment and may disadvantage other deserving job applicants. There are also concerns about the efficiency of tax credits as an incentive to potential employees to enter the job market, as well as an incentive for employers to retain such employees after they no longer qualify for the tax credit. It is argued that basing of the credit on only the first two years of a person's employment motivates employers to replace an employee whose wages no longer qualify for the tax credit with another employee whose wages do qualify. For a more detailed discussion of these issues, refer to the analysis section of the extension of the work opportunity tax credit, immediately above.

Prior Action

A similar proposal was included in the President's fiscal year 2001 budget proposal.[141]

3. Extend alternative minimum tax relief for individuals

Prior and Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[142] the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit).

For taxable years beginning in 2001, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

Without an extension of these rules for taxable years beginning after 2001, these credits (other than the adoption credit, child credit and IRA credit) would be allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

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[141] P.L. 107-147, "The Job Creation and Worker Assistance Act of 2002," extended the credit for two years.

[142] A portion of the child credit may be refundable.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Subsequent to the submission of the President's budget to Congress, P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," extended the rules allowing these credit to offset both the regular tax and the alternative minimum tax to taxable years beginning during 2002 and 2003.

Description of Proposal

The proposal would allow an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits in taxable years beginning in 2002 and 2003.

Effective date.--The proposal would be effective for taxable years beginning in 2002 and 2003.

Analysis of Complexity and Policy Issues

Allowing the personal credits to offset the regular tax and alternative minimum tax results in significant simplification. Substantially fewer taxpayers need to complete the alternative minimum tax form (Form 6251), and the forms and worksheets relating to the various credits can be simplified.[143]

The Congress, in legislation relating to expiring provisions in recent years, has determined that allowing these credits to fully offset the regular tax and alternative minimum tax

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[143] For a recommendation that the repeal of the individual alternative minimum tax will result in significant tax simplification, see Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Vol. II at 2.

would not undermine the policy of the individual alternative minimum tax and would promote the important social policies underlying each of the credits.

The following example compares the effect of not extending minimum tax relief with the effect of the proposal extending minimum tax relief:

Example.--Assume in 2002, a married couple has an adjusted gross income of $70,000, they do not itemize deductions, and they have four dependent children, two of whom are eligible for the child tax credit and two of whom are eligible for the maximum HOPE Scholarship credit. The couple's net tax liability without an extension of the rules, and with an extension, are computed as shown in Table 8.

Table 8 -- Comparison of Individual Tax Liability Without Extension of Rules and With Extension

	Without Extension	Proposal (With Extension)
Adjusted gross income	$70,000	$70,000
Less standard deduction	7,850	7,850
Less personal exemptions (6 @ $3,000)	18,000	18,000
Taxable income	44,150	44,150
Regular tax	6,022	6,022
Tentative minimum tax	5,460	5,460
HOPE Scholarship credit before limitation	3,000	3,000
Tentative minimum tax limitation:		
Regular tax	6,022	6,022
Less tentative minimum tax	5,460	0
Limitation	562	6,022
HOPE Scholarship credit	562	3,000
Child tax credit	1,200	1,200
Net tax	4,260	1,822
Net tax reduction		2,438

Prior Action

A similar proposal was contained in the President's fiscal year 2002 budget proposal.[144]

[144] P.L. 107-147, "The Job Creation and Worker Assistance Act of 2002," extended for two years the rules allowing certain nonrefundable credits to offset the regular tax and the alternative minimum tax.

4. Extension of exceptions under Subpart F for active financing income

Prior and Present Law

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[145]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct

[145] Temporary exceptions from the subpart F provisions for certain active financing income originally applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. Subsequent to the submission of the President's budget to Congress, the temporary exceptions were extended for five years, with a modification, by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002."

substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

Subsequent to the submission of the President's budget to Congress, the temporary exceptions were extended for five years, with a modification, by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002."

Description of Proposal

The proposal would extend for two years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective date.--The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2001, and before January 1, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

Analysis of Complexity and Policy Issues

Complexity issues

By extending the provisions, the proposal would provide some continuity and stability in the tax law. By making the law predictable during the extension period, the proposal would simplify tax planning during that period for taxpayers and tax practitioners.

It could be argued that extending the provisions permanently would have a greater stabilizing benefit than extending the provisions temporarily (setting aside any other policy concerns). A permanent extension would facilitate long-range business planning, for example,

by eliminating the uncertainty caused by a temporary extension with respect to the pricing of long-term contracts that are acquired or entered into while the provisions are in effect, but that extend after the provisions are scheduled to expire. Some might argue that applying the provisions to contracts entered into during the period the provisions are effective (rather than to taxable years of a taxpayer for which the provisions are effective) might alleviate this uncertainty, but others would argue that vintaging contracts in this manner would add to the complexity of the provisions, not reduce complexity.

As a general matter, the temporary exceptions to Subpart F that would be extended under the proposal can be described as detailed and complex. Because of the high level of complexity of the exceptions provided by the underlying provisions, it could be argued that not extending the provisions would serve to reduce complexity in the tax law.

Policy issues

Aside from issues relating to complexity, the exceptions to Subpart F provided under the provision raise several policy issues. When enacting the exceptions in their current form, Congress acknowledged that the subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of a CFC of income that is either passive or highly mobile. Exceptions from the subpart F rules had been provided for income derived in the active conduct of a banking, financing, or similar business, or income derived from certain investments made by an insurance company, under the law prior to the Tax Reform Act of 1986, which repealed the exceptions. In enacting the temporary exceptions to the subpart F rules in 1997 and 1998, Congress recognized that the earlier repeal of those exceptions by the 1986 Act might be viewed as causing the subpart F rules to apply to income that is neither passive nor highly mobile.[146] Advocates of this view would argue that in the case of a bank, financing, or insurance business, income (e.g., interest) that might otherwise be considered passive or highly mobile is actually earned in the active conduct of their core business activities. Thus, subjecting this income to inclusion under subpart F would arguably cause U.S.-based financial services companies to be treated more harshly than both U.S.-based manufacturing companies and foreign-based financial services companies.

On the other hand, if it is generally appropriate to impose current U.S. tax on highly mobile income earned through a CFC, exceptions to rules of inclusion under subpart F may encourage U.S. persons to conduct some types of activities overseas through CFCs in order to gain the tax benefits of income deferral outside of the subpart F rules. In repealing some of the deferral under subpart F in 1986, Congress noted that "by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices are placed on a more even footing, thus

[146] See S. 949, the "Revenue Reconciliation Act of 1997," as reported by the Senate Committee on Finance, S. Rep. No. 105-33, at 89-90 (1997); H.R. 4738, "Extension of Expiring Provisions and Other Tax Relief," as reported by the House Committee on Ways and Means, H.R. Rep. No. 105-817, at 34 (1998).

encouraging more efficient (rather than more tax-favored) uses of capital."[147] It could thus be argued that the tax system could be made more neutral and could better serve the goal of economic efficiency if the exceptions were not provided.

Prior Action

No prior action.[148]

5. Extend suspension of net income limitation on percentage depletion from marginal oil and gas wells

Prior and Present Law

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset--in the case of depletion for oil or gas interests, the mineral reserve itself--is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling).

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[149] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

Cost depletion

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method; and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units

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[147] See H.R. 3838, the "Tax Reform Act of 1985," as reported by the House Committee on Ways and Means, H.R. Rep. No. 99-426, at 391-397 (1985); H.R. 3838, the "Tax Reform Act of 1986," as reported by the Senate Committee on Finance, S. Rep. No. 99-313, at 363 (1986).

[148] P.L. 107-147, "The Job Creation and Worker Assistance Act of 2002," extended the Subpart F temporary exceptions for five years.

[149] Treas. Reg. sec. 1.611-1(b)(1).

remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Percentage depletion and related income limitations

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[150] Generally, under the percentage depletion method 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). By contrast, for any other mineral qualifying for the percentage depletion deduction, such deduction may not exceed 50 percent of the taxpayer's taxable income from the depletable property. A similar 50-percent net-income limitation applied to oil and gas properties for taxable years beginning before 1991. Section 11522(a) of the Omnibus Budget Reconciliation Act of 1990 prospectively changed the net-income limitation threshold to 100 percent only for oil and gas properties, effective for taxable years beginning after 1990. The 100-percent net-income limitation for marginal wells was suspended for taxable years beginning after December 31, 1997, and before January 1, 2002.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[151] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

[150] Sec. 613A.

[151] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,[152] are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Extension of the suspension

Subsequent to the submission of the President's budget to Congress, the 100-percent net-income limitation for marginal wells was suspended for taxable years beginning after December 31, 2001, and before January 1, 2004, by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002."

Description of Proposal

The suspension of the 100-percent net-income limitation for marginal wells would be extended for two years. Thus, the limitation would not apply for taxable years beginning after December 31, 2001 and before January 1, 2004.

Effective date.--The proposal would be effective on date of enactment for taxable years after December 31, 2001.

Analysis of Complexity and Policy Issues

The proposal adds complexity to the Code in that its temporary nature introduces a degree of uncertainty for taxpayers, i.e., whether the provision will be the subject of further extensions. This in turn causes the need for additional advance tax planning in the event the suspension is not extended further.

The additional extension of the suspension provides additional time to evaluate the need for modification to the provision. On the other hand, some might argue that since the suspension already has been in place for four years, a permanent decision could be made based on that four-year period, providing certainty to taxpayers.

Prior Action

No prior action.[153]

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[152] This exception is limited to wells, the drilling of which began between September 30, 1978, and January 1, 1984.

[153] P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," suspended the 100-percent net-income limitation for marginal wells for taxable years beginning after December 31, 2001, and before January 1, 2004. Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and S. 1979, the "Energy Tax Incentives Act of 2002," as reported by the Senate Committee on Finance (S. Rep.

6. Re-enact authority to issue qualified zone academy bonds

Prior and Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments were given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds was authorized to be issued annually in calendar years 1998 through 2001. The $400 million aggregate bond cap was allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocated the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department set the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond was determined by the Treasury Department, so that the present value of the obligation to repay the bond was 50 percent of the face value of the bond.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment

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No. 107-140, 2002), would extend the suspension of the 100-percent net income limitation for five years from December 31, 2001.

zones enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Subsequent to the submission of the President's budget to Congress, P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," authorized the issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

Description of Proposal

The proposal would authorize issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

Effective date.--The provision is effective for obligations issued after the date of enactment.

Analysis of Complexity and Policy Issues

Complexity issues

A temporary extension provides some stability in the qualified zone academy bonds program. Certainty that the program would continue at least temporarily, without further interruption or modification, arguably would facilitate financial planning by taxpayers during that period. The uncertainty that results from expiring provisions may adversely affect the administration of and perhaps the level of participation in such provisions. For example, a taxpayer may not be willing to devote the time and effort necessary to satisfy the complex requirements of a provision that expires shortly. Similarly, the Internal Revenue Service must make difficult decisions about the allocation of its limited resources between permanent and expiring tax provisions.

Some argue that a permanent or long-term extension is necessary to encourage optimal participation among potential QZAB issuers. Others respond that the permanent repeal of expiring provisions such as the QZAB rules that are inherently complex would provide the same level of certainty for tax planning purposes as a long-term or permanent extension, and would further reduce the overall level of complexity in the Code. A related argument is that programs such as qualified zone academy bonds would be more efficient if administered as direct expenditure programs rather than as a part of the tax law.

Policy issues

The proposal to extend qualified zone academy bonds would subsidize a portion of the costs of new investment in public school infrastructure and, in certain qualified areas, equipment and teacher training. By subsidizing such costs, it is possible that additional investment will take place relative to investment that would take place in the absence of the subsidy. If no additional investment takes place than would otherwise, the subsidy would merely represent a transfer of funds from the Federal Government to States and local governments. This would enable States

and local governments to spend the savings on other government functions or to reduce taxes.[154] In this event, the stated objective of the proposals would not be achieved.

Though called a tax credit, the Federal subsidy for tax credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or local government that benefits from the bond proceeds.[155] To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal Government would make outlays of $100 in interest payments, but would recoup $28 of that in tax receipts, for a net budgetary cost of $72, as before. Similarly, the bondholder/taxpayer would receive a taxable $100 in interest, and would owe $28 in taxes, for a net gain of $72, as before. The State or local government also would be in the same situation in both cases.

The proposed tax credit regime to subsidize public school investment raises some questions of administrative efficiencies and tax complexity (see above). Because potential purchasers of the zone academy bonds must educate themselves as to whether the bonds qualify for the credit, certain "information costs" are imposed on the buyer. Additionally, since the determination as to whether the bond is qualified for the credit ultimately rests with the Federal Government, further risk is imposed on the investor. These information costs and other risks

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[154] Most economic studies have found that when additional funding is made available to localities from outside sources, there is indeed an increase in public spending (this is known as the "fly-paper" effect, as the funding tends to "stick" where it is applied). The additional spending is not dollar for dollar, however, implying that there is some reduction of local taxes to offset the outside funding. See Harvey Rosen, *Public Finance*, second ed., 1988, p. 530 for a discussion of this issue.

[155] This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.

serve to increase the credit rate and hence the costs to the Federal Government for a given level of support to the zone academies. For these reasons, and the fact that tax credit bonds will be less liquid than Treasury Securities, the bonds would bear a credit rate that is equal to a measure of the yield on outstanding corporate bonds.

The direct payment of interest by the Federal Government on behalf of States or localities, which was discussed above as being economically the equivalent of the credit proposal, would involve less complexity in administering the income tax, as the interest could simply be reported as any other taxable interest. Additionally, the tax credit approach implies that non-taxable entities would only be able to invest in the bonds to assist school investment through repurchase agreements or by acquiring rights to repayment of principal if a tax credit bond is stripped. In the case of a direct payment of interest, by contrast, tax-exempt organizations would be able to enjoy such benefits.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal.[156]

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[156] P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," authorized the issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

B. Other Extensions

1. Permanently extend provisions expiring in 2010

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") made a number of changes to the Federal tax laws, including: reducing individual tax rates, repealing the estate tax, increasing and expanding various child-related credits, providing tax relief to married couples, providing additional education-related tax incentives, increasing and expanding various pension and retirement-saving incentives, and providing individuals relief relating to the alternative minimum tax. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974, the Act included a "sunset" provision, pursuant to which the provisions of the Act expire at the end of 2010. Specifically, the Act's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010.

The Act provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though the Act had never been enacted. For example, the estate tax, which the Act repeals for decedents dying in 2010, will return as to decedents dying after 2010, in pre-Act form, without the various interim changes made by the Act (e.g., the rate reductions and exemption equivalent amount increases applicable to decedents dying before 2010). Similarly, the top individual marginal income tax rate, which the Act gradually reduces to 35 percent by 2006, will return to its pre-Act level of 39.6 percent in 2011 under present law. Likewise, all other provisions of the Code and ERISA will be applied as though the relevant provisions of the Act had never been enacted.

Description of Proposal

The proposal would repeal the sunset provision of the Act and thus would permanently extend all provisions of the Act that expire at the end of 2010. Thus, the estate tax would remain repealed after 2010, and the individual rate reductions and other provisions of the Act that are in effect in 2010 would remain in place after 2010.[157]

Analysis of Complexity and Policy Issues

In general

The policy merits of permanently extending the provisions of the Act that expire at the end of 2010 depend on considerations specific to each provision. In general, however, advocates of eliminating the sunset provision may argue that it was never anticipated that the sunset actually would be allowed to take effect, and that eliminating it promptly would promote

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[157] However, certain provisions expire separately under the Act before the end of 2010. For example, the increased AMT exemption amount provided under the Act expires after 2004 and thus would be unaffected by the proposal.

stability and rationality in the tax law. In this view, if the sunset were eliminated, other rules of the Act that phase in or phase out provisions over the immediately preceding years would be made more rational. On the other hand, others may argue that certain provisions of the Act would not have been enacted at all, or would not have been phased in or phased out in the same manner, if the sunset provision had not been included in the Act.

Complexity issues

The present-law sunset provision arguably contributes to complexity by requiring taxpayers to contend with (at least) two different possible states of the law in planning their affairs. For example, under the sunset provision, an individual planning his or her estate will face very different tax regimes depending on whether the individual dies in 2010 (estate tax repealed) or 2011 (estate tax not repealed). This "cliff effect" requires taxpayers to plan an estate in such a way as to be prepared for both contingencies, thereby creating a great deal of complexity. On the other hand, some may argue that this kind of uncertainty is always present to some degree -- with or without a sunset provision, taxpayers always face some risk that the Congress will change a provision of law relevant to the planning of their affairs. Others may acknowledge this fact, but nevertheless argue that the sunset provision creates an unusual degree of uncertainty and complexity as to the areas covered by the Act, because they consider it unlikely that the sunset will actually go into effect. In this view, the sunset provision leaves taxpayers with less guidance as to the future state of the law than is usually available, making it difficult to arrange their affairs. In addition to the complexity created by the need to plan for the sunset, uncertainty about the timing and details of how the sunset might be eliminated arguably creates further complexity.

Even if it is assumed that the sunset provision will take effect, it is not clear how the sunset would apply to certain of the Act's provisions. It would be relatively simple to apply the sunset to some provisions, such as the individual rate reductions. With respect to other provisions, however, further guidance would be needed as to the effect of the sunset. For example, if the Code will be applied after 2010 as if the Act had never been enacted, then one possible interpretation of the pension provisions is that contributions made while the Act was in effect will no longer be valid, possibly resulting in the disqualification of plans. While this result was likely not intended, without further guidance taxpayers may be unsure as to the effect of the sunset.

More broadly, in weighing the overall complexity effects of the present-law sunset and the proposed sunset repeal, some would point out that the sunset provision is not the only feature of the Act that generates "cliff effects" and similar sources of uncertainty and complexity for taxpayers. For example, under the Act's estate tax provisions, a decedent dying in 2008 has an exemption equivalent amount of $2 million, one dying in 2009 has an exemption equivalent amount of $3.5 million, and one dying in 2010 effectively has an infinite exemption. Thus, the estates of individuals at certain wealth levels will incur significant estate tax if they die in 2008, but none at all if they die in 2009; the estates of individuals at other wealth levels will incur significant estate tax if they die in 2009, but none at all if they die in 2010. These discontinuities are not caused by the sunset provision, but they generate a similar sort of uncertainty and complexity for many taxpayers. Similar phase-ins and phase-outs are found in other provisions of the Act and generate complexity and uncertainty, irrespective of whether the Act as a whole

sunsets or not. In light of these issues, some may argue that a more detailed reconsideration of the Act or certain of its provisions would better serve the goal of tax simplification.

Beyond phase-ins and phase-outs, some may argue that the Act included other provisions that increased the complexity of the Code, and that allowing those provisions to expire at the end of 2010 (or effectively requiring that they be reconsidered before then) may reduce complexity, albeit potentially years in the future. Others would argue that some of the Act's provisions reduced complexity, such as the repeal of the overall limitation on itemized deductions and changes relating to the earned income tax credit, and that permanently extending these provisions would contribute to simplification of the tax laws.

Prior Action

No prior action.[158]

2. Extend the research tax credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after June 30, 2004.

A 20-percent research tax credit also applied to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is

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[158] This or a similar proposal has been included in a number of bills introduced in the 107th Congress (e.g., H.R. 2316, H.R. 2327, and H.R. 2599). In addition, other bills have been introduced that would repeal the sunset of the Act as to certain provisions (e.g., H.R. 2143 (estate tax and related provisions), H.R. 2212 (individual income tax rate reductions), and H.R. 3050 (same)). The Senate also has passed, as Senate Amendment 2850 to S. 1731 (an agriculture reauthorization bill), a provision expressing the Sense of the Senate that the Act's sunset should be repealed as to the estate tax provisions (i.e., that estate tax repeal should be made permanent).

computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[159]

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a

[159] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[160]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may

[160] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be made permanent.

Effective date.--The proposal would be effective on the date of enactment.

Complexity and Policy Analysis

Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm are cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency.[161] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. It is difficult to determine whether, at the present levels of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency. There is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[162]

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach

[161] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

[162] See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, XCIV, (1992), M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993, and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates" Griliches, p. S43.

the optimal level. Among the other policies employed by the Federal Government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little evidence about the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should increase research activities beyond what they otherwise would be. However, the present-law treatment of research expenditures does create certain complexities and compliance costs.

The scope of present-law tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit is estimated to be $5.0 billion for 2002. The related tax expenditure for expensing of research and development expenditures is estimated to be $4.5 billion for 2002 growing to $5.0 billion for 2006.[163] As noted above, the Federal Government also directly subsidizes research activities. For example, in fiscal 2001 the National Science Foundation made $3.4 billion in grants, subsidies, and contributions to research activities, the Department of Defense financed $9.1 billion in basic research, applied research, and advanced technology development, and the Department of Energy financed $10 billion in research in high energy physics and nuclear physics and $161 million for research in advance scientific computing.[164]

Table 9 and Table 10 present data for 1999 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. In 1999, more than 14,000 taxpayers claimed more than $5 billion in research tax credits. Nearly three quarters of the research tax credits claimed were claimed by taxpayers whose primary activity is manufacturing. More than 85 percent of the credits claimed were claimed by firms with assets of $50 million or more. Nevertheless, as Table 10 documents, a large number of small firms are engaged in research and were able to claim the research tax credit.

[163] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006* (JCS-1-02), January 17, 2002, p. 20.

[164] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003*, Appendix, pp. 1035, 295-298, and 394.

Table 9.--Percentage Distribution of Firms Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 1999

Industry	Percent of Corporations	Percent of total R & E Credit
Manufacturing	6.03	73.23
Information	2.18	11.90
Professional, Scientific, and Technical Services	13.31	8.30
Finance and Insurance	4.41	2.05
Wholesale Trade	7.09	1.84
Retail Trade	12.08	0.62
Health Care and Social Services	6.15	0.41
Utilities	(1)	(1)
Transportation and Warehousing	3.25	0.26
Holding Companies	0.88	0.24
Agriculture, Forestry, Fishing and Hunting	2.87	0.19
Administrative and Support and Waste Management and Remediation Services	4.15	0.17
Construction	11.76	0.12
Mining	0.62	0.06
Other Services	6.19	0.04
Arts, Entertainment, and Recreation	1.90	0.04
Real Estate and Rental and Leasing	10.56	0.03
Accommodation and Food Services	5.11	0.03
Educational Services	0.71	0.01
Wholesale and Retail Trade not Allocable	(1)	(1)
Not Allocable	(1)	(1)

[1] Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation calculations from Internal Revenue Service, Statistics of Income data.

Table 10.--Percentage Distribution of Firms Claiming Research Tax Credit and of Amount of Credit Claimed by Firm Size, 1999

Asset Size ($)	Percent of Firms	Percent of Credit Claimed
0	6.34	1.56
1 to 100,000	51.31	0.14
100,000 to 250,000	16.04	0.11
250,000 to 500,000	9.68	0.18
500,000 to 1 Million	6.70	0.49
1 to 10 Million	8.37	5.09
10 to 50 Million	0.98	6.29
50 million and more	0.57	86.09

Source: JCT calculations from Internal Revenue Service, Statistics of Income data.

Incremental tax credits

For a tax credit to be effective in increasing a taxpayer's research expenditures it is not necessary to provide that credit for all the taxpayer's research expenditures. By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives where they will have the most effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of $105 and Project B will generate cash flow with present value of $95. Suppose that the cost of investing in each of these projects is $100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Consider now the situation where a 10-percent flat credit applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to $90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to $90, this previously neglected project (with a present value of $95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits attempt not to reward projects that would have been undertaken in any event and to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures.[165] Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental

[165] In the example above, if an incremental credit were properly targeted, the Government could spend the same $20 in credit dollars and induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded $80.

credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's Abase amount. Tax credits are provided only for amounts above this base amount.

Since a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures considered below their base amount receive no credit.

The responsiveness of research expenditures to tax incentives

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of Aprice elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.[166] One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.[167]

[166] For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity--such as research scientists and engineers--is in short supply.

[167] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise--so called marginal research expenditures--need be subject to the credit to have a positive incentive effect.

Despite the central role of the measurement of the price elasticity of research activities, there is little empirical evidence on this subject. What evidence exists generally indicates that the price elasticity for research is substantially less than one. For example, one survey of the literature reached the following conclusion:

> In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of -0.2 and -0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.[168]

Although most analysts agree that there is substantial uncertainty in these estimates, the general consensus when assumptions are made with respect to research expenditures is that the price elasticity of research is less than 1.0 and may be less than 0.5.[169] Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

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[168] Charles River Associates, An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive (final report prepared for the National Science Foundation), February, 1985, p. G-14.

[169] In a 1983 study, the Treasury Department used an elasticity of .92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. See, Department of the Treasury, The Impact of Section 861-8 Regulation on Research and Development, p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerable smaller. For example, the General Accounting Office summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." See, *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3." See, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191.

More recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to fully appreciate the incentive structure of the revised credit. See, Bronwyn H. Hall, "R&D Tax Policy During the 1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, 7, pp. 1-35 (Cambridge: The MIT Press, 1993). Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, including an

Other policy issues related to the research and experimentation credit

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below base, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the alternative minimum tax (AMT) or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[170]

Under present law, firms with research expenditures substantially in excess of their base amount may be subject to the 50-percent limitation. In general, although these firms receive the

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additional 76 firms, that had initially been excluded because they had been involved in merger activity, the estimated elasticities fell by half. See, James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s" in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, (Chicago: University of Chicago Press 1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, "R&D Tax Incentives and Manufacturing-Sector R&D Expenditures," in James M. Poterba, editor, *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment*, (Washington, D.C.: National Academy Press), 1997. While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, "Does Government R&D Policy Mainly Benefit Scientists and Engineers?" *American Economic Review*, 88, May, 1998, pp. 298-302.

[170] As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

largest amount of credit when measured as a percentage of their total qualified research expenditures, their marginal effective rate of credit is exactly one half of the statutory credit rate of 20 percent (i.e., firms on the base limitation effectively are governed by a 10-percent credit rate).

Although the statutory rate of the research credit is currently 20 percent, it is likely that the average marginal effective rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms are subject to various limitations discussed above yields estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate i.e., between 12 and 15 percent.[171]

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will Adrift from the firm's actual current qualified research expenditures. Therefore, increasingly over time there will be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms receive no credit and have no reasonable prospect of ever receiving a credit, while other firms receive large credits (despite the 50-percent base limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average marginal effective rate of credit will decline while the revenue cost to the Federal Government increases.

Complexity and the research tax credit

Administrative and compliance burdens also result from the present-law research tax credit. The General Accounting Office ("GAO") has testified that the research tax credit is difficult for the IRS to administer. The GAO reports that the IRS view is that it is required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes. While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.[172] An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

[171] For a more complete discussion of this point see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 65-66.

[172] Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate, April 3, 1995.

> Tax incentives such as the R&D tax credit … typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. … [I]s what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.[173]

Prior Action

The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years. The research tax credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate, university basic research credit.

The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") extended the research tax credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also modified the method for calculating a taxpayer's base amount (i.e., by substituting the present-law method which uses a fixed-base percentage for the prior-law moving base which was calculated by reference to the taxpayer's average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1990 extended the research tax credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

The Tax Extension Act of 1991 extended the research tax credit for six months (i.e., for qualified expenses incurred through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the research tax credit for three years--i.e., retroactively from July 1, 1992 through June 30, 1995. The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience.

[173] David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, 50, September 1997, pp. 487-493.

Although the research tax credit expired during the period July 1, 1995, through June 30, 1996, the Small Business Job Protection Act of 1996 ("1996 Act") extended the credit for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime). In addition, the 1996 Act expanded the definition of start-up firms under section 41(c)(3)(B)(I), enacted a special rule for certain research consortia payments under section 41(b)(3)(C), and provided that taxpayers may elect an alternative research credit regime (under which the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage otherwise applicable and the credit rate likewise is reduced) for the taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997.

The Taxpayer Relief Act of 1997 ("1997 Act") extended the research credit for 13 months--i.e., generally for the period June 1, 1997, through June 30, 1998. The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury). The Tax and Trade Relief Extension Act of 1998 extended the research credit for 12 months, i.e., through June 30, 1999.

The Ticket To Work and Work Incentive Improvement Act of 1999 extended the research credit for five years, through June 30, 2004, increased the rates of credit under the alternative incremental research credit regime, and expanded the definition of research to include research undertaken in Puerto Rico and possessions of the United States.

VI. OTHER PROVISIONS MODIFYING THE INTERNAL REVENUE CODE

A. Electronic Tax Return Filing

Present Law

The IRS encourages taxpayers to file their tax returns electronically; it calls its program to do so "e-file." In 2001, approximately 40 million individual income tax returns were filed using e-file.[174] Most of the taxpayers who filed electronically had their returns prepared by return preparers or by return preparation software. In general, taxpayers must pay for these return preparation services or software.[175] In some instances, an additional charge must be paid to the return preparation service or software provider to utilize e-file, while in other instances there is no additional charge beyond the return preparation fee. Taxpayers who wish to participate in e-file must do so through a third party; they cannot file their returns electronically directly[176] with the IRS.[177]

The IRS Restructuring and Reform Act of 1998 stated that it is the policy of the Congress that paperless filing should be the preferred and most convenient means of filing Federal tax and information returns and that it should be the goal of the IRS to have at least 80 percent of all such returns filed electronically by 2007.[178] In 2001, 30.9 percent of all individual income tax returns were filed electronically.[179]

Description of Proposal

The proposal[180] would permit taxpayers to file their Federal tax returns on-line for free, without the intervention of a third party.

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[174] IRS' 2001 Tax Filing Season, GAO-02-144, p. 14.

[175] Some return preparers offer free return preparation and e-file services to some taxpayers, such as those with low incomes.

[176] By contrast, several States currently permit taxpayers to file their State tax returns directly by electronic means, without the intervention of a third party.

[177] Some taxpayers are permitted to file Form 1040EZ via touch-tone telephone directly with the IRS for no charge. This program is called "TeleFile."

[178] P.L. 105-206, July 22, 1998, sec. 2001(a).

[179] This includes returns that were filed via touch-tone telephone as part of TeleFile. IRS' 2001 Tax Filing Season, GAO-02-144, p. 14.

[180] *Budget of the U.S. Government for Fiscal Year 2003*, p. 274.

Effective date.--The proposal would be effective for returns filed after December 31, 2002.[181]

Analysis of Complexity and Other Issues

The annual filing of tax returns is one of the primary obligations that the government imposes on citizens. Some believe that the government should minimize the costs and burdens of complying with such obligations, which the proposal is intended to do. In recent years, many taxpayers have found it beneficial to conduct business and personal transactions and to communicate information online. Often, doing so reduces costs and increases convenience. The current system for electronic filing of tax returns may not, for some taxpayers, be more cost effective or more convenient than paper filing. The proposal could increase the possibilities for cost reduction and added convenience for taxpayers. In addition, because the proposal would encourage increased utilization of electronic filing, it would assist in reaching the electronic filing goal articulated in the IRS Restructuring and Reform Act and could reduce the tax return processing costs of the IRS.

There are several benefits to e-file, such as much more rapid receipt of a refund, increased accuracy, and acknowledgment of receipt of the tax return. Under the proposal, taxpayers would not be required to pay third parties for return preparation services or for software in order to receive these benefits.

Some might object to the proposal because they believe that the government would be assuming a function currently performed by the private sector. Others might respond that preparation of tax returns by third parties existed long before electronic filing was a possibility, and that taxpayers who have previously found return preparation to be a beneficial service[182] are likely to continue to do so. Since the government will not charge for this service, some might view the proposal as permitting the government to unfairly compete with the private sector. Others would respond that because the IRS does not charge third parties for electronic filing, there is no unfair competition. They would also respond that the proposal in fact treats taxpayers who choose to use a paid preparer and those who do not more equitably, whereas under the current system the government is favoring those who purchase return preparation services or software over those who choose not to make those purchases. The proposal does not specify the nature of the software that the government will have to make available for taxpayers to utilize the proposal. The more detailed the software, the more concerns may be raised about private sector competition. All of these issues have been dealt with in those States that currently permit taxpayers to file their State tax returns directly by electronic means, without the intervention of a third party.

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[181] Office of Management and Budget, *E-Government Strategy*, February 27, 2002, p. 14.

[182] Of the individual income tax returns for tax year 1999, 54.5 percent were prepared by paid return preparers. IRS Statistics of Income-1999, Individual Income Tax Returns, (Pub. 1304) Table A and Statistics of Income Bulletin Summer 2001 (Pub. 1136), Table 23.

The proposal does not specify whether it is applicable to all taxpayers or only to individuals. Similarly, the proposal does not specify whether it is applicable to all Federal tax forms or only to federal income tax forms. It is possible that the proposal could be implemented administratively; no legislative change may be needed.

Prior Action

No prior action.

B. Extend Access to Tax Information for the Department of Veterans Affairs

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the IRS and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The Office of Inspector General of DVA has reported that, because of deficiencies in the DVA's means-testing process, the IRS terminated the disclosure of tax information to DVA relating to health care eligibility under this provision in July 1999.[183] This termination remains in effect.

The DVA disclosure provision is scheduled to expire after September 30, 2003.

Description of Proposal

The proposal would permanently extend the authority to disclose tax information to the DVA.[184]

Effective date.--The proposal would be effective on the date of enactment.

Analysis of Complexity and Policy Issues

Some might argue that it is appropriate to permit the disclosure of otherwise confidential tax information to ensure the correctness of the government benefit payments. Others might

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[183] Office of Inspector General, DVA, Audit of the Department of Veterans Affairs Health Eligibility Center, Atlanta, Georgia (Report No. 00-02165-54, March 26, 2001), p. 1.

[184] Appendix, *Budget of the United States for Fiscal Year 2003*, p. 858.

respond that tax information should be used only for tax purposes and should not be subject to widespread redisclosure by the IRS.

Some believe that the proposal would not increase complexity, in that it is a permanent extension of present law. Others would respond that, because the present-law provision is not currently operational due to deficiencies at DVA, extending the proposal permanently (assuming it becomes operational again at some future point) would increase complexity for both taxpayers (who would need to respond to questions arising from the use of the information and expend resources to correct inaccuracies in the use of the information) and the IRS (which must monitor DVA to assure that the deficiencies that caused termination of the program do not arise again).

Prior Action

No prior action.

APPENDIX

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

February 20, 2002

Ms. Lindy L. Paull
Chief of Staff
Joint Committee on Taxation
Washington, D.C. 20515

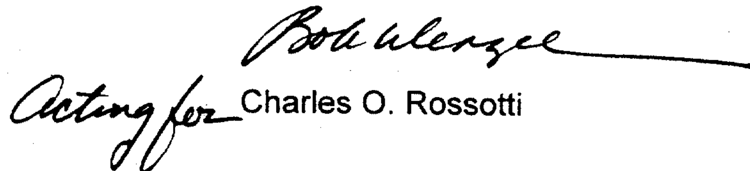
FEB 2 1 2002

Dear Ms. Paull:

I am writing in response to your letters of February 7, 2002, to Treasury Assistant Secretary Weinberger and me in which you requested information relating to the impact of the revenue proposals in the Administration's FY 2003 budget on the complexity and administration of the Internal Revenue Code. We applaud the effort by the Joint Committee on Taxation to provide the Congress such information on a timely basis.

Enclosed are the combined comments of the Internal Revenue Service and the Treasury Department on the complexity and administration of eight individual income tax proposals in the Administration's budget. These eight are the only revenue proposals in the Administrations budget that have "widespread applicability," the threshold for complexity analysis set in Section 4022 of the Restructuring Act. Given the short time in which you desire a reply, we have limited our review to provisions meeting this threshold.

Sincerely,



Acting for Charles O. Rossotti

Enclosure

COMMENTS ON COMPLEXITY AND ADMINISTRATION OF REVENUE PROPOSALS IN THE ADMINISTRATION'S BUDGET FOR FY 2003 THAT HAVE WIDESPREAD APPLICABILITY

Provide Charitable Contribution Deduction for Non-Itemizers

Proposal:

Taxpayers who do not itemize would be allowed to deduct contributions to qualified charitable organizations in addition to claiming the standard deduction. The deduction would be phased in between 2002 and 2012, as follows: (1) Taxpayers (other than married taxpayers filing joint returns) would be allowed a maximum deduction of $100 in 2002 through 2004, $300 in 2005 through 2011, and $500 in 2012 and subsequent years. (2) Married taxpayers filing a joint return would be allowed a maximum deduction of $200 in 2002 through 2004, $600 in 2005 through 2011, and $1,000 in 2012 and subsequent years. The non-itemizer deduction would not be a preference item for alternative minimum tax purposes and would not affect the calculation of AGI.

IRS and Treasury Comments:

- Two lines would be added to Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ and to the TeleFile Tax Record beginning in 2002. No new forms would be required.

- The new deduction would also be reflected on Form 1040-ES for 2003 and in the instructions for Forms 1040X and 1045 beginning in 2002. Subsequent to enactment, the IRS would advise taxpayers who make estimated tax payments for 2002 how to adjust their estimated tax payments for 2002 to reflect the new deduction.

- The phase-in of the amount of the deduction would be reflected in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ and for TeleFile for 2005 and 2012. The phase-in of the amount of the deduction would also be reflected on Form 1040-ES for 2005 and 2012.

- Information necessary for taxpayers to determine their eligibility for the deduction would be reflected in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ and for TeleFile beginning in 2002.

- This proposal would require programming modifications to allow for additional line items on the tax returns.

- Script and other changes would be required to allow the deduction to taxpayers who use TeleFile.

- Charitable deductions are not subject to third party information reporting to the IRS, so verification of amounts deducted is through examination.

Refundable Tax Credit for the Purchase of Health Insurance

Proposal:

The proposal would create a refundable income tax credit for the cost of health insurance purchased by individuals under age 65. The credit would provide a subsidy of up to 90 percent of the maximum allowable health insurance premium, up to a maximum credit of $1,000 per adult and $500 per child for up to two children. The maximum subsidy percentage of 90 percent would apply for low-income taxpayers and would be phased down at higher incomes.

Individuals could claim the tax credit for health insurance premiums paid as part of the normal tax-filing process. Alternatively, the tax credit would be available in advance at the time the insurance is purchased. Individuals would reduce their premium payment by the amount of the credit and the health insurer would be reimbursed by the Department of the Treasury for the amount of the advance credit. Eligibility for the advance credit would be based on the individual's prior year tax return.

The health insurance tax credit would be effective for taxable years beginning after December 31, 2002, and would be available in advance beginning July 2003.

IRS and Treasury Comments:

- One new form for computing the health insurance tax credit would be required beginning in 2003.
- One line for entering the tax credit would be added to Forms 1040, 1040A, and 1040NR beginning in 2003.
- Information alerting taxpayers to the advance credit option would be reflected in the instructions for Forms 1040, 1040A, 1040EZ, 1040NR, and 1040NR-EZ for 2002.
- The new tax credit would be reflected on Form 1040-ES for 2003 and in the instructions for Forms 1040X, 1045, and 8853 beginning in 2003.
- The mechanism for implementing the advance payment option would need to be put in place. The mechanism requires systems to verify taxpayers' eligibility for the advance credit and to reimburse health insurers for their premium reductions.
- Health insurers would be required to provide information statements to advance credit claimants and to the IRS, including the policy number, the policy premium, and that the policy meets the requirements for a qualified policy.

- This proposal would require programming modifications to allow for additional line items on the tax returns, a new form, and the computation of the credit. This proposal also would require programming to implement the systems needed to verify taxpayers' eligibility for the advance credit and to reimburse health insurers.

Provide an Above-the-Line Deduction for Long-Term Care Insurance Premiums

Proposal:

The proposal would allow individuals purchasing qualified long-term care insurance a deduction in determining AGI up to the annual dollar limitations that currently apply to the deductibility of long-term care insurance. The deduction would be effective for taxable years beginning on or after January 1, 2004, but would be phased in so that 25 percent of the premium would be deductible for 2004, 35 percent for 2005, 65 percent for 2006, and 100 percent for 2007 and thereafter.

IRS and Treasury Comments:

- A line for entering the deduction would be added to Forms 1040, 1040A, and 1040NR beginning in 2004. No new forms would be required.

- The deduction would also be reflected on Form 1040-ES for 2004 and in the instructions for Forms 1040X and 1045 beginning in 2004.

- The phase-in of the amount of the deduction would be reflected in the instructions for Forms 1040, 1040A, and 1040NR and on Form 1040-ES for 2005 through 2007.

- Information necessary for taxpayers to determine their eligibility for the deduction would be reflected in the instructions for Forms 1040, 1040A, and 1040NR beginning in 2004. Information alerting taxpayers to the deduction would also be reflected in the instructions for Forms 1040EZ and 1040NR-EZ and for TeleFile beginning in 2004.

- Programming changes would be required to reflect the new line item on the tax returns.

- Health insurers would be required to provide information statements to policyholders, including the amount of the premium and certifying that the policy meets the requirements for a qualified policy.

Allow up to $500 in Unused Benefits in a Health Flexible Spending Arrangement to be Carried Forward to the Next Year

Proposal:

Effective for plan years beginning after December 31, 2003, an employer's cafeteria plan health FSA could permit up to $500 in amounts available for an employee's medical expenses but not used during the plan year to be carried forward to the employee's account for the next plan year of the health FSA.

IRS and Treasury Comments:

- No new forms would be required, and no existing forms would need to be revised.
- Employers permitting a carryforward would have to amend existing cafeteria plans.
- Employers permitting carryforwards in their plans would have to maintain records of employee elections.
- Employees making elections would have to read election instructions and complete election forms, as required by employers.
- When the existing proposed regulations §1.125-1 and §1.125-2 are finalized, the "use it or lose it rule" would have to be modified. This would include the specific rules applicable to FSAs in §1.125-2, Q&A 7, and the provisions dealing with deferral of compensation (1.125-1, Q&A 7 and 1.125-2 Q&A 5).
- To determine the limits on contributions to qualified plans, the regulations under §415 may need to be amended to clarify when the $500 carryforward counts as compensation for §415 purposes (i.e., in year 1, year 2, or both).

Provide Additional Choice with Regard to Unused Benefits in a Health Flexible Spending Arrangement

Proposal:

Effective for plan years beginning after December 31, 2003, an employer's cafeteria plan could permit up to $500 in amounts available but not used for medical expenses during the plan year to be distributed to the employee or contributed to a 401(k) plan, 403(b) plan, governmental 457(b) plan, or Medical Savings Account (MSA). Amounts distributed would be subject to income tax withholding and employment taxes. Amounts contributed to a 401(k) or other plan or MSA would be subject to the normal rules (e.g., contribution limits, discrimination tests, withdrawal restrictions, employment taxes) applicable to elective contributions to the receiving plan or MSA.

IRS and Treasury Comments:

- All the comments applicable to the previous provision are applicable to this provision.

- Section 1.105-2 of the regulations would need to be modified to allow a Code §105(b) exclusion because up to $500 is available to the employee irrespective of whether or not he or she incurs expenses for medical care. When the proposed regulations §1.125-1 Q&A 17 are finalized, they would also have to be modified to reflect the exception to the §1.105-2 regulation.

- Rules governing the interaction of this provision (including the previously discussed $500 FSA carry forward proposal) with other employee benefit provisions would need to be worked out.

- If the plan provides different options, employees would have to file an election specifying how their unused funds are to be applied.

Extend the Due Date for Electronically Filed Returns

Proposal:

The proposal would extend the return filing and payment date for the filing of individual income tax returns from April 15 to April 30, if the return is filed electronically. In order to qualify for this extended return due date, any balance due must be paid electronically by the extended return due date. The due date would remain April 15 for returns filed on paper and for electronically filed returns where balances due are not paid electronically.

IRS and Treasury Comments:

Tax Forms

- No form changes would be required.

- The instructions for all individual income tax returns would need to be revised to reflect the new due date for certain electronically-filed returns.

Programming and Processing

- In order to process returns that would meet the new due-date requirements, computer programs would have to be modified, tested, and put into place. Programming changes would be made to properly identify returns eligible for the later filing date, to accurately compute late filing and late payment penalties, and to accurately compute interest, either owed to the government for late payment or owed to the taxpayer for late refund issuance.

- The scripts for the TeleFile system would need to be changed to incorporate the new due date and to inform taxpayers of the requirement to pay any balance due electronically in order to qualify for the April 30 due date.

- The IRS would need to work with vendors of tax preparation software and members of the tax preparation community to make them aware of the change in the due date for electronically filed returns and payments.

Regulations and Guidance

- Taxpayers would not be required to keep additional records if this proposal is implemented.

- The IRS would need to modify regulations and provide guidance.

- The IRS would need to have an extensive Communications Plan for communicating the change both externally and internally. If requirements for the extended due date are not communicated clearly, taxpayers could become confused and file a late return resulting in penalty and interest charges.

- The IRS would need to include information in its annual training materials for its employees on the change of due date. Internal Revenue Manuals would also need to be modified.

Extend Minimum Tax Relief for Individuals

Proposal:

The proposal would allow an individual to reduce tax liability by the full amount of nonrefundable personal credits even if tax liability is reduced to an amount that is less than the individual's tentative minimum tax. The proposal would be effective for taxable years beginning after December 31, 2001, and before January 1, 2004.

IRS and Treasury Comments:

- Because this proposal merely extends the 2001 rules to 2002 and 2003, no immediate form or programming changes would be required.

- Subsequent to enactment, the IRS would have to advise taxpayers who make estimated tax payments for 2002 how to adjust their payments for 2002 to reflect the proposal.

- If the proposal is not enacted, at least two lines would be added to the affected credit forms.

- If this proposal is not enacted, millions of taxpayers will be required to complete worksheets and Form 6251 to determine whether their personal tax credits will be limited by the AMT. In addition, failure to extend minimum tax relief for 2002 and later years would significantly increase the complexity of these credits.

- It is critical that this proposal be enacted as soon as possible to avoid costly and unnecessary programming changes

Permanently Extend Expiring Provisions

Provision:

The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 that sunset on December 31, 2010 would be permanently extended.

IRS and Treasury Comments:

- No form or programming changes would be needed provided the proposal is enacted prior to the time the IRS would have to begin taking steps to restore the pre-EGTRRA rules.

- If this proposal is not enacted, massive changes to tax forms and instructions (and related programming) for the sunset year would be required.

- If this proposal is not enacted, the changes in the sunset year would be both burdensome and confusing for taxpayers.