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DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2005 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions modifying the Internal Revenue Code of 1986 (the "Code") that are contained in the President's fiscal year 2005 budget proposal, as submitted to the Congress on February 2, 2004.[2] The document generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's budget proposal.[3] For each provision, there is a description of present law and the proposal (including effective date), an analysis of issues related to the proposal and a reference to relevant prior budget proposals or recent legislative action.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal* (JCS-3-04), February 2004.

[2] *See* Office of Management and Budget*, Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives* (H. Doc. 108-146, Vol. III), pp. 239-270.

[3] *See* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, February 2004.

I. MAKING PERMANENT THE TAX CUTS ENACTED IN 2001 AND 2003

A. Extend Through 2010 Certain Provisions Relating to Individuals

Present Law

Ten-percent regular income tax rate

Table 1, below, shows the scheduled size of the 10-percent regular income tax rate bracket for the next several years.

Table 1.–Scheduled Size of 10-Percent Regular Income Tax Rate Bracket

Year	Unmarried Taxpayers	Joint Returns	Heads of Household
2003-2004[1]	$7,000	$14,000	$10,000
2005-2007[2]	$6,000	$12,000	$10,000
2008-2010[3]	$7,000	$14,000	$10,000
2011[4]	No 10-Percent Bracket		

[1] The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted for inflation for taxable years beginning in 2004 only.
[2] No inflation adjustment.
[3] The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008.
[4] The 10-percent regular income tax rate bracket is repealed for taxable years beginning after December 31, 2010, under the sunset provision of the Economic Growth Tax Relief Reconciliation Act of 2001 ("EGTRRA"). A separate proposal in the budget eliminates the sunset.

Basic standard deduction marriage penalty relief

The basic standard deduction amount for married taxpayers filing a joint return is twice the basic standard deduction amount for single individuals for taxable years beginning in 2003 and 2004. For taxable years beginning in 2005-2008, the relationship between the standard deduction for joint filers and single filers reverts to amounts less than twice the basic standard deduction for single individuals, but which gradually increases under the provisions of EGTRRA until 2009 when the basic standard deduction amount for married taxpayers filing a joint return again equals twice the basic standard deduction amount for single individuals. For taxable years

beginning in 2011 and thereafter, the size of the basic standard deduction for joint filers is less than twice the basic standard deduction for single individuals,[4] as determined prior to EGTRRA.

Marriage penalty relief in the 15-percent rate bracket for married couples filing joint returns

The size of the 15-percent regular income tax rate bracket for married taxpayers filing joint returns is twice the width of the 15-percent regular income tax rate bracket for single returns for taxable years beginning in 2003 and 2004. For taxable years beginning in 2005-2007, the size of the 15-percent regular income tax rate bracket for married taxpayers filing a joint return reverts to levels less than twice the width of the 15-percent regular income tax rate bracket for single returns, but which gradually increase under the provisions of EGTRRA until they are again twice the width of the 15-percent regular income tax rate bracket for single returns for taxable years beginning in 2008-2010. For taxable years beginning in 2011 and thereafter, the size of the 15-percent regular income tax rate bracket for married taxpayers filing joint return is less than twice the width of the 15-percent regular income tax rate bracket for single returns.[5]

Child credit

The child credit is $1,000 for taxable years beginning in 2003 and 2004. The child credit is reduced to $700 for taxable years beginning in 2005-2008 and to $800 for taxable years beginning in 2009. The child credit becomes $1,000 for taxable years beginning in 2010 and drops to $500 for taxable years beginning in 2011 and thereafter.[6]

Description of Proposal

The proposal eliminates the scheduled reductions for taxable years beginning before 2009 in the (1) 10-percent rate bracket, (2) basic standard deduction for married taxpayers filing jointly, (3) fifteen-percent rate bracket for married taxpayers filing jointly, and (4) child credit.[7]

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[4] A separate proposal in the budget eliminates the sunset provision that causes this reduction in tax benefits for taxable years beginning after 2010.

[5] A separate proposal in the budget eliminates the sunset provision that causes this reduction in tax benefits for taxable years beginning after 2010.

[6] A separate proposal in the budget eliminates the sunset provision that causes this reduction in tax benefits for taxable years beginning after 2010.

[7] A separate proposal in the budget eliminates the scheduled sunset of these provisions for taxable years beginning after December 31, 2010.

Analysis

Analysis of complexity and policy issues for acceleration proposals

Some may argue that this proposal to eliminate the pre-2009 reductions raises only macroeconomic issues. That is, the proposal only raises issues regarding the budgetary effects of maintaining higher levels for the provisions rather than temporarily reducing them as scheduled, because the underlying microeconomic policy choices (e.g., reducing the marriage penalty) have already been made. However, it can also be argued that the current Congress and President, or a future Congress and President, could rescind these provisions before they go into effect, and thus these policies are not truly current policy until their respective effective dates. In this view, since the actual future implementation of these policies is not guaranteed, making the policies effective immediately raises policy issues specific to the individual proposals, and not just macroeconomic issues with respect to the timing of a proposal. These policy issues are briefly discussed below. Macroeconomic issues arise with any tax changes that significantly alter the budget surplus or deficit, and in general are not discussed here.

Ten percent regular income tax rate and reduction of other regular income tax rates

Altering the tax bracket sizes and rate structure raises the general issue of the progressivity of the income tax structure, or the degree to which the average tax rate rises with income. There is no "right" degree of progressivity, and individuals will disagree as to the proper degree of progressivity. Greater progressivity produces a more equal after-tax distribution of income in society, which many will argue enhances the stability of society. Others argue that the more progressive is the tax structure, the more individual initiative and risk taking is stifled as the government takes a growing share of the economic returns to work and investment.

On balance, the 10-percent bracket and the reduction in rates, as provided for in EGTRRA, had only modest effects on the progressivity of the rate structure, as the rates were all reduced by approximately 10 percent, with the new 10-percent bracket substituting for a reduction in the 15-percent rate. However, for taxpayers with incomes significantly below the top of the 15-percent bracket, the effect of the 10-percent rate bracket was to reduce taxes paid by significantly more than 10 percent, and thus on balance the rate structure was made more progressive.

Marriage penalty relief

Marriage penalty equity issues

Any system of taxing married couples requires making a choice among three different concepts of tax equity. One concept is that the tax system should be "marriage neutral;" that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second concept of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. (This second concept of equity could apply equally well to other tax units that may consume jointly, such as the extended family or the household, defined

as all people living together under one roof.) A third concept of equity is that the income tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three. The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally. It specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But the current tax system is not marriage neutral.[8] A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality, unless it were to forgo progressivity.

There is disagreement as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality.[9] Those who hold marriage neutrality to be more important tend to focus on marriage penalties that may arise under present law and argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with $20,000 of income are equally well off regardless of whether their income is divided $10,000-$10,000 or $15,000-$5,000. Thus, it is argued, those two married couples should pay the same tax, as they do under present law. By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal income division.

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[8] Even when the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) are half of those for married couples filing a joint return, the tax system would not be marriage neutral. Many married couples would still have marriage bonuses. As described below, the joint return in such a system would allow married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple in which one spouse has $60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with $30,000 of income. With progressive taxation, the tax liability on $30,000 would be less than half of the tax liability on $60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

[9] This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax (i.e., a single rate on all income for all taxpayers) system. A proportional system would automatically produce marriage neutrality and equal taxation of couples with equal incomes.

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, other activities or leisure. It could, of course, be argued in response that the "leisure" of the non-earner may in fact consist of necessary job hunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.[10]

Under present law, beginning in 2005 the sum of the basic standard deductions two unmarried individuals would receive exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals.[11] Furthermore, because of the way the bracket breakpoints are structured, particularly beginning in 2005, taxpayers filing joint returns may have more of their taxable income pushed into a higher marginal tax bracket than when they were unmarried. In order for there to be no marriage penalties as a result of the rate structure and the basic standard deduction, the basic standard deduction and the bracket breakpoints for married taxpayers filing joint returns would have to be at least twice that for both single and head of household filers. Such a structure would enhance marriage bonuses, however. By maintaining the increased standard deduction for married couples and the increased size of the 15-percent bracket for married couples filing a joint return, the President's proposal eliminates the marriage penalty arising from the rate structure for most taxpayers.[12] It does not necessarily improve the marriage-neutrality of the tax system, as the proposal enhances marriage bonuses.

Marriage penalty efficiency issues

Most analysts discuss the marriage penalty as an issue of fairness, but the marriage penalty also may create economic inefficiencies. The marriage penalty may distort taxpayer behavior. The most obvious decision that may be distorted is the decision to marry. For taxpayers for whom the marriage penalty exists, the tax system increases the "price" of marriage. For taxpayers for whom the marriage bonus exists, the tax system reduces the "price" of marriage. Most of what is offered as evidence of distorted choice is anecdotal. Research finds that marriage penalties have little or no effect on taxpayers' decisions to marry. Even if the

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[10] If the two-earner couple had child care expenses many would think that the single-earner couple with children and the same income would have a greater ability to pay taxes as the family would benefit from the unpaid labor of the stay-at-home spouse with regard to child care.

[11] Because lower-income taxpayers are more likely to use the standard deduction, this feature of present law is a more significant part of the marriage penalty for lower-income taxpayers relative to higher-income taxpayers.

[12] The 10-percent bracket for married taxpayers filing jointly is already twice that of singles. Marriage penalties will still exist for certain upper bracket taxpayers.

marriage decision were distorted, it would be difficult to measure the cost to society of delayed or accelerated marriages or alternative family structures.[13]

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. For example, suppose a woman currently in the 25-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $7,950 of his earnings would be tax-free.[14] However, because he marries a woman in the 25-percent income tax bracket, if he becomes employed he would have a tax liability of 25 cents on his first dollar of earnings, leaving a net of 75 cents for his labor.[15] Filing a joint return may distort the man's decision regarding whether to enter the work force. If he chooses not to work, society loses the benefit of his labor. Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate.[16]

The possible disincentive effects of a higher marginal tax rate on the secondary worker arise in the case of couples who experience a marriage bonus as well. In the specific example above, the couple consisted of one person in the labor force and one person not in the labor force.

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[13] Marriage bonuses may similarly distort taxpayer behavior.

[14] As a single taxpayer, the man could claim the standard deduction of $4,850 and one personal exemption of $3,100 for 2004, effectively exempting the first $7,950 of his earnings. This example ignores payroll taxes.

[15] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 25-percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 25-percent bracket as a single filer the combined income of the couple would place them in the 15-percent bracket for married couples. In this case the marginal tax rate with respect to the income tax for the man would have increased from 0 to 15 percent, while that of the woman would have fallen from 25 percent to 15 percent.

[16] *See* Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, 75, March 1985, for a review of econometric studies on labor supply of so-called primary and secondary earners. CBO, *For Better or Worse*, at 10-12, also reviews this literature.

As noted previously, such a circumstance generally results in a marriage bonus. By filing a joint return, the lower earner may become subject to the marginal tax rate of the higher earner. By creating higher marginal tax rates on secondary earners, joint filing may discourage a number of individuals from entering the work force or it may discourage those already in the labor force from working additional hours.[17]

By maintaining the size of the fifteen-percent bracket for married taxpayers filing jointly at twice that of single taxpayers, single taxpayers in the fifteen percent bracket or below will not, under the President's proposal, experience a higher marginal tax rate from marriage. Thus, the labor supply of "secondary earners" is less likely to be discouraged under the President's proposal.

Expansion of child tax credit

One of the basic tenets of tax policy is that an accurate measurement of ability to pay taxes is essential to tax fairness. Proponents of maintaining the size of the child credit at $1,000 argue that anything less would be inadequate, even if taken together with the personal exemption available for each qualifying child, to adequately reflect the cost of raising a child. They argue that the higher credit better reflects the reduced ability to pay of taxpayers with children. Others argue that the full financial cost of raising a child should not be presumed to be a public responsibility, and that the child credit and dependent exemptions are not designed to fully offset the costs of raising a child.

Prior Action

The President's budget proposal for fiscal year 2004 contained a similar acceleration proposal for taxable years beginning in 2003 and 2004.

[17] The decision to work additional hours may be less sensitive to changes in the marginal tax rate than the decision to enter the labor force. *See*, Robert K. Triest, "The Effect of Income Taxation on Labor Supply in the United States," *Journal of Human Resources*, 25, 1990.

B. Permanently Extend Certain Provisions Expiring Under EGTRRA and JGTRRA

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") 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, EGTRRA included a "sunset" provision, pursuant to which the provisions of the Act expire at the end of 2010. Specifically, EGTRRA'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.

EGTRRA 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 EGTRRA had never been enacted. For example, the estate tax, which EGTRRA repeals for decedents dying in 2010, will return as to decedents dying after 2010, in pre-EGTRRA 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 EGTRRA gradually reduced to 35 percent by 2006,[18] will return to its pre-EGTRRA level of 39.6 percent in 2011 under present law. Likewise beginning in 2011, all other provisions of the Code and ERISA will be applied as though the relevant provisions of EGTRRA had never been enacted.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA")

In general

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") changed the tax treatment of certain expensing, individual capital gains rates and the tax rate on dividends received by individuals. The expensing provision sunsets for taxable years beginning after December 31, 2005. The capital gains and dividend provisions sunset for taxable years beginning after December 31, 2008.

Expensing provisions

JGTRRA provides that the maximum dollar amount that may be deducted under section 179 is increased to $100,000 for property placed in service in taxable years beginning before 2006. In addition, for purposes of the phase-out of the deductible amount, the pre-JGTRRA

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[18] The Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the reduction to 35 percent for 2004 and thereafter.

$200,000 amount at which the phase-out begins is increased to $400,000 for property placed in service in taxable years beginning before 2006. The dollar limitations are indexed annually for inflation for taxable years beginning before 2006. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning before 2006 as qualifying property. With respect to taxable years beginning before 2006, the provision permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner.

Individual capital gains rates

Under JGTRRA, for taxable years beginning before January 1, 2009, generally the maximum rate of tax on net capital gain of a non-corporate taxpayer is 15 percent. In addition, any net capital gain which otherwise would have been taxed at a 10- or 15-percent rate generally is taxed at a five-percent rate (zero for taxable years beginning after 2007). For taxable years beginning after December 31, 2008, generally the rates on net capital gain are 20-percent and 10-percent, respectively. Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate.

Taxation of dividends received by individuals

Under JGTRRA, dividends received by a non-corporate shareholder from domestic corporations and qualified foreign corporations generally are taxed at the same rates that apply to net capital gain. Thus, dividends received by an individual, estate, or trust are taxed at rates of five (zero for taxable years beginning after 2007) and 15 percent. This treatment applies to taxable years beginning before January 1, 2009.

For taxable years beginning after December 31, 2008, dividends received by a non-corporate shareholder are taxed at the same rates as ordinary income.

Description of Proposal

The proposal repeals the sunset provisions of EGTRRA and JGTRRA.

Specifically, the proposal permanently extends all provisions of EGTRRA that expire at the end of 2010. Thus, the estate tax remains repealed after 2010, and the individual rate reductions and other provisions of the Act that are in effect in 2010 will remain in place after 2010.[19]

Also, the proposal permanently extends the provisions of JGTRRA relating to expensing, capital gains, and dividends.

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[19] However, certain provisions expire separately under the Act before the end of 2010. For example, the increased AMT exemption amounts expire after 2004 and thus is unaffected by the proposal.

Effective date.–The proposal is effective on the date of enactment.

Analysis

In general

The policy merits of permanently extending the provisions of EGTRRA and JGTRRA that sunset depend on considerations specific to each provision. In general, however, advocates of eliminating the sunset provisions may argue that it was never anticipated that the sunset actually would be allowed to take effect, and that eliminating them promptly would promote stability and rationality in the tax law. In this view, if the sunsets were eliminated, other rules of EGTRRA and JGTRRA 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 EGTRRA and JGTRRA would not have been enacted at all, or would not have been phased in or phased out in the same manner, if the sunset provisions had not been included in EGTRRA and JGTRRA, respectively.

Complexity issues

The present-law sunset provisions of EGTRRA and JGTRRA arguably contribute 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 of EGTRRA, 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 of EGTRRA 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 provisions will take effect, it is not clear how the sunsets would apply to certain provisions. It would be relatively simple to apply the EGTRRA 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 EGTRRA 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 sunsets and the proposed sunset repeal, some would point out that the sunset provisions are not the only feature of EGTRRA and JGTRRA that generates "cliff effects" and similar sources of uncertainty and complexity for taxpayers. For example, under EGTRRA'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 provisions, 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 EGTRRA and generate complexity and uncertainty, irrespective of whether EGTRRA as a whole sunsets or not. In light of these issues, some may argue that a more detailed reconsideration of the EGTRRA or certain of its provisions would better serve the goal of tax simplification.

Beyond phase-ins and phase-outs, some may argue that EGTRRA 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 EGTRRA'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

A similar proposal was included in the President's fiscal year 2003 and 2004 budget proposals.

II. TAX INCENTIVES

A. Provisions Related to Savings

1. Expansion of tax-free savings opportunities

Present Law

In general

Present law provides for a number of vehicles that permit individuals to save on a tax-favored basis. These savings vehicles have a variety of purposes, including encouraging saving for retirement, encouraging saving for particular purposes such as education or health care, and encouraging saving generally.

The present-law provisions include individual retirement arrangements, qualified retirement plans and similar employer-sponsored arrangements, Coverdell education savings accounts, qualified tuition programs, health savings accounts, Archer medical savings accounts, annuity contracts, and life insurance. Certain of these arrangements are discussed in more detail below.

Individual retirement arrangements ("IRAs")

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[20] to which both deductible and nondeductible contributions may be made,[21] and Roth IRAs.[22] The Federal income tax rules regarding each type of IRA (and IRA contributions) differ.

The maximum annual deductible and nondeductible contributions that can be made to a traditional IRA and the maximum contribution that can be made to a Roth IRA by or on behalf of an individual varies depending on the particular circumstances, including the individual's income. However, the contribution limits for IRAs are coordinated so that the maximum annual contribution that can be made to all of an individual's IRAs is the lesser of a certain dollar amount ($3,000 for 2004)[23] or the individual's compensation. In the case of a married couple,

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[20] Sec. 408.

[21] Sec. 219.

[22] Sec. 408A.

[23] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the dollar limit on IRA contributions to $3,000 for 2004, $4,000 for 2005 through 2007, and $5,000 for 2008. After 2008, the limit is adjusted for inflation in $500 increments. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010. Thus, the dollar limit on annual IRA contributions returns to $2,000 in 2011. A proposal to

contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. As a result, the maximum deduction for IRA contributions for an individual who has attained age 50 is increased by a certain dollar amount ($500 for 2004).[24] Under present law, IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Table 2.–AGI Phase-Out Range for Deductible IRA Contributions

Single Taxpayers	
Taxable years beginning in:	*Phase-out range*
2004	45,000-55,000
2005 and thereafter	50,000-60,000
Joint Returns	
Taxable years beginning in:	*Phase-out range*
2004	65,000-75,000
2005	70,000-80,000
2006	75,000-85,000
2007 and thereafter	80,000-100,000

The adjusted gross income phase-out range for married taxpayers filing a separate return is $0 to $10,000.

make the EGTRRA provisions that expire on December 31, 2010, permanent is discussed in Part I.B of this document.

[24] Under EGTRRA, the additional amount permitted for catch-up contributions to an IRA is $500 for 2004 and 2005 and $1,000 for 2006 and thereafter. As a result of the general sunset provision of EGTRRA, catch-ups contributions are not permitted after 2010.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions. An individual who has attained age 50 before the end of the taxable year may also make nondeductible catch-up contributions to an IRA.

An individual who has attained age 70-½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Early withdrawals from an IRA generally are subject to an additional 10-percent tax.[25] That is, includible amounts withdrawn prior to attainment of age 59-½ are subject to an additional 10-percent tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of adjusted gross income, is used to purchase health insurance of certain unemployed individuals, is used for higher education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Distributions from traditional IRAs generally are required to begin by the April 1 of the year following the year in which the IRA owner attains age 70-½. If an IRA owner dies after minimum required distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the IRA owner dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the IRA owner's death. The five-year rule does not apply if distributions begin within one year of the IRA owner's death and are payable over the life or life expectancy of a designated beneficiary. Special rules apply if the beneficiary of the IRA is the surviving spouse.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of a certain dollar amount ($3,000 for 2004) or the individual's compensation for the year. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a Roth IRA up to a certain dollar amount ($500 for 2004).

The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with

[25] Sec. 72(t).

adjusted gross income between $95,000 and $110,000 and for joint filers with adjusted gross income between $150,000 and $160,000. The adjusted gross income phase-out range for married taxpayers filing a separate return is $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

Taxpayers with modified adjusted gross income of $100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. To determine the amount includible in income, a distribution that is not a qualified distirbution is treated as made in the following order: (1) regular Roth IRA contributions; (2) conversion contributions (on a first-in, first-out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. The amount includible in income is also subject to the 10-percent early withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs.

Saver's credit

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[26] The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Taxpayers filing joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return. The credit is available with respect to contributions to

[26] Sec. 25B. The Saver's credit does not apply to taxable year's beginning after January 31, 2006.

various types of retirement savings arrangements, including contributions to a traditional or Roth IRA.

Coverdell education savings accounts

Present law 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 higher education expenses of a designated beneficiary.[27] The aggregate annual contributions that can be made by all contributors to Coverdell education savings accounts for the same beneficiary is $2,000 per year. In the case of contributors who are individuals, the maximum contribution limit is reduced for individuals with adjusted gross income between $95,000 and $110,000 ($190,000 to $220,000 in the case of married taxpayers filing a joint return).[28]

Distributions from a Coverdell education savings account are not includible in the distributee's income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a Coverdell education savings account exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a Coverdell education savings account may be rolled over to another Coverdell education savings account of the same beneficiary or of a member of the family of that beneficiary.

Qualified tuition programs[29]

Present law provides tax-exempt status to a qualified tuition program, defined as a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions.[30] Under a qualified tuition program, a person may purchase tuition credits or certificates on behalf of a designated beneficiary, or in the case of a

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[27] Sec. 530.

[28] The present-law contribution limit and the adjusted gross income levels are subject to the general sunset provision of EGTRRA. Thus, for example, the limit on annual contributions to a Coverdell education savings account is $500 after 2010. A proposal to repeal the income limits on contributions to Coverdell education savings accounts is discussed in Part III.G.3 of this document.

[29] A proposal relating to qualified tuition programs is discussed in Part V.M of this document.

[30] Sec. 529. The general sunset provision of EGTRRA applies to certain aspects of the rules for qualified tuition programs, including tuition programs maintained by one or more eligible educational institutions (which may be private institutions). Thus, for example, after 2010 a qualified tuition program may be established and maintained only by a State or agency or instrumentality thereof.

State program, may make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. Contributions to a qualified tuition program must be made in cash, and the program must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions to a qualified tuition program generally are treated as a completed gift eligible for the gift tax annual exclusion.

Distributions from a qualified tuition program are not includible in the distributee's gross income to the extent that the total distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. If a distribution from a qualified tuition program exceeds the qualified education expenses incurred by the beneficiary during the year of the distribution, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

<u>Health savings accounts</u>

Effective for taxable years beginning after December 31, 2003, a health savings account ("HSA") is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for qualified medical expenses.[31] Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and employment taxes if made by the individual's employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent, unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. A high deductible health plan is a health plan that has a deductible that is at least $1,000 for self-only coverage or $2,000 for family coverage (indexed for inflation) and that has an out-of-pocket expense limit that is no more than $5,000 in the case of self-only coverage and $10,000 in the case of family coverage.

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an Archer MSA high deductible health plan under present law, as adjusted for inflation. For 2004, the amount of the maximum deductible under an Archer MSA high deductible health plan is $2,600 in the case of self-only coverage and $5,150 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise

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[31] Sec. 223.

applicable limit by $500 in 2004, $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

Archer medical savings accounts ("MSAs")

An Archer medical savings account ("MSA") is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for medical expenses.[32] Within limits, contributions to an Archer MSA are deductible if made by an individual and are excludable from income and employment taxes if made by the individual's employer. Distributions from an Archer MSA for qualified medical expenses are not taxable.

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. For purposes of MSAs, a high deductible plan is a health plan with an annual deductible (for 2004) of at least $1,700 and no more than $2,600 in the case of individual coverage and at least $3,450 and no more than $5,150 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 $3,450 in the case of individual coverage and no more than $6,300 in the case of family coverage (for 2004).

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level. After 2003, no new contributions may 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.

Description of Proposal

In general

The proposal consolidates traditional and Roth IRAs into a single type of account, a Retirement Savings Account ("RSA"). The proposal also creates a new type of account that can be used to save for any purpose, a Lifetime Savings Account ("LSA").

The tax treatment of both RSAs and LSAs is generally similar to that of present-law Roth IRAs; that is, contributions are not deductible and earnings on contributions generally are not taxable when distributed. The major difference between the tax treatment of LSAs and RSAs is that all distributions from LSAs are tax free, whereas tax-free treatment of earnings on amounts in RSAs applies only to distributions made after age 58 or in the event of death or disability.

Retirement Savings Accounts

Under the proposal, an individual may make annual contributions to an RSA up to the lesser of $5,000[33] or the individual's compensation for the year. As under present-law rules for

[32] Sec. 220.

[33] The contribution limit is indexed for inflation.

IRAs, in the case of a married couple, contributions of up to the dollar limit may be made for each spouse, if the combined compensation of both spouses is at least equal to the total amount contributed for both spouses. Contributions to an RSA may be made regardless of the individual's age or adjusted gross income. Contributions to an RSA may be made only in cash. Contributions to an RSA are taken into account for purposes of the Saver's credit. Earnings on contributions accumulate on a tax-free basis.

Qualified distributions from RSAs are excluded from gross income. Under the proposal, qualified distributions are distributions made after age 58 or in the event of death or disability. Distributions from an RSA that are not qualified distributions are includible in income (to the extent that the distribution exceeds basis) and subject to a 10-percent additional tax. As under the present-law rules for Roth IRAs, distributions are deemed to come from basis first.

As under the present-law rules for Roth IRAs, no minimum distribution rules apply to an RSA during the RSA owner's lifetime. In addition, married individuals may roll amounts over from an RSA to a spouse's RSA.

Under the proposal, existing Roth IRAs are renamed RSAs and are subject to the rules for RSAs. In addition, existing traditional IRAs may be converted into RSAs . The amount converted is includible in income (except to the extent it represents a return of nondeductible contributions). No income limits apply to such conversions. For conversions of traditional IRAs made before January 1, 2006, the income inclusion may be spread ratably over four years. For conversions of traditional IRAs made on or after January 1, 2006, the income that results from the conversion is included for the year of the conversion.

Under the proposal, existing traditional IRAs that are not converted to RSAs may not accept new contributions, other than rollovers from other traditional IRAs or employer-sponsored retirement plans. New traditional IRAs may be created to accept rollovers from employer-sponsored retirement plans or other traditional IRAs, but they cannot accept any other contributions. An individual may roll an amount over directly from an employer-sponsored retirement plan to an RSA by including the rollover amount (excluding basis) in income, similar to a conversion to a Roth IRA under present law.

Amounts converted to an RSA from a traditional IRA or an Employer Retirement Savings Account ("ERSA")[34] are subject to a five-year holding period. If an amount attributable to such a conversion (other than amounts attributable to a Roth-type account in an ERSA) is distributed from the RSA before the end of the five-year period starting with the year of the conversion or, if earlier, the date on which the individual attains age 58, becomes disabled, or dies, an additional 10-percent tax applies to the entire amount. The five-year period is determined separately for each conversion distribution. To determine the amount attributable to a conversion, a distribution is treated as made in the following order: (1) regular RSA contributions; (2) conversion contributions (on a first-in, first-out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made

[34] The proposal relating to ERSAs is discussed in Part II.A.2 of this document.

first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion.

Lifetime Savings Accounts

Under the proposal, an individual may make nondeductible contributions to an LSA of up to $5,000 annually, regardless of the individual's age, compensation, or adjusted gross income.[35] Additionally, individuals other than the LSA owner may make contributions to an LSA. The contribution limit applies to all LSAs in an individual's name, rather than to the individuals making the contributions. Thus, contributors may make annual contributions of up to $5,000 each to the LSAs of other individuals but total contributions to the LSAs of any one individual may not exceed $5,000 per year. Contributions to LSAs may be made only in cash. Contributions to an LSA are not taken into account for purposes of the Saver's credit. Earnings on contributions accumulate on a tax-free basis.

All distributions from an individual's LSA are excludable from income, regardless of the individual's age or the use of the distribution. As under the present-law rules for Roth IRAs, no minimum distribution rules apply to an LSA during the LSA owner's lifetime. In addition, married individuals may roll amounts over from an LSA to a spouse's LSA.

Control over an LSA in a minor's name is to be exercised exclusively for the benefit of the minor by the minor's parent or legal guardian acting in that capacity until the minor reaches the age of majority (determined under applicable state law).

Taxpayers may convert balances in Coverdell education savings accounts and qualified tuition programs to LSA balances. All conversions must be made before January 1, 2006, and are subject to certain limitations. An amount may be rolled over to an individual's LSA only if the individual was the beneficiary of the Coverdell education savings account or qualified tuition program as of December 31, 2003. The amount that can be rolled over to an LSA from a Coverdell education savings account is limited to the sum of: (1) the amount in the Coverdell education savings account as of December 31, 2003; and (2) any contributions to and earnings on the account for 2004. The amount that can be rolled over to an LSA from a qualified tuition program is limited to the sum of: (1) the lesser of $50,000 or amount in the qualified tuition program as of December 31, 2003; and (2) any contributions to and earnings on the qualified tuition program for 2004. The total amount rolled over to an individual's LSAs that is attributable to 2004 contributions for the individual to Coverdell education savings accounts and qualified tuition programs cannot exceed $5,000 (plus any earnings on such contributions).

Under the proposal, qualified tuition programs continue to exist as separate arrangements, but may be offered in the form of an LSA. For example, State agencies that administer qualified tuition programs may offer LSAs with the same investment options that are available under the qualified tuition program. The annual limit on LSA contributions apply to such an LSA, but the

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[35] Total contributions to an LSA for a year may not exceed $5,000, regardless of whether any distributions are taken from the LSA during the year. The contribution limit is indexed for inflation.

additional reporting requirements applicable to qualified tuition programs under present law do not apply and distributions for purposes other than education are not subject to Federal tax.[36]

Effective date

The proposal is effective on January 1, 2005.

Analysis

In general

The proposal is intended to accommodate taxpayers' changing circumstances over time by providing a new account that taxpayers may use for tax-favored saving over their entire lifetimes, with no restrictions on withdrawals. The proposal also provides a new account for individual retirement savings with fewer restrictions on eligibility than present-law IRAs. The proposal is intended to simplify saving by permitting the consolidation of existing savings accounts and allowing individuals to make contributions to these new accounts with no limitations based on age or income level.

By providing additional tax incentives for saving, the proposal intends to encourage additional saving. By providing a tax-favored savings account with no restrictions on withdrawals, the proposal intends to encourage additional saving by those who are reluctant to take advantage of existing tax-preferred savings accounts because of withdrawal restrictions. Some argue that the national saving rate is too low, and that this is due in part to the bias of the present-law income tax structure against saving and in favor of current consumption. By providing tax incentives for saving--specifically, removing the tax on the return to saving--the present-law income tax structure can be modified to function more like a consumption tax. Proponents of such tax incentives argue that saving will increase if the return to saving is not reduced by taxes. Others have argued that saving has not necessarily increased as a result of existing tax incentives for savings. Some have argued that much existing savings have merely been shifted into tax-favored accounts, and thus do not represent new saving.[37] Others have argued that increasing the return to savings (by not taxing earnings) might cause some taxpayers actually to save less, as a higher return to savings means that less saving is necessary to achieve a "target" level of savings at some point in the future.

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[36] State tax law and qualified tuition program investment options may provide incentives for savings used for educational purposes.

[37] Unlike present-law IRAs, an LSA does not require that contributions be no greater than compensation. Under the proposal, regardless of income, an individual may make nondeductible annual contributions to an LSA of up to $5,000. To the extent an individual makes contributions to his or her own LSA that exceed his or her income, then the amounts transferred in excess of income must represent a transfer of assets from existing savings and not new savings from forgoing current consumption. Additionally, individuals other than the LSA owner may make contributions to an LSA.

From an economic perspective, both LSAs and RSAs receive tax treatment generally equivalent to Roth IRAs. While the taxpayer does not deduct contributions to LSAs, tax is never paid on the income earned on the investment. The same is generally true for RSAs as long as amounts are withdrawn in qualified distributions. However, while LSAs and RSAs receive similar tax treatment to Roth IRAs, the maximum allowable annual contribution is greater than the amount of contributions currently permitted to Roth IRAs. The increase in the amounts that may be contributed to tax-preferred savings accounts provides a tax incentive for further saving for those who have already contributed the maximum to existing tax-favored savings accounts. However, for taxpayers not already contributing the maximum amounts, the new accounts provide no additional inducement to save.[38] Opponents of proposals to increase tax-favored saving thus argue that the only beneficiaries are likely to be wealthy taxpayers with existing savings that will be shifted to the tax-favored accounts, since most taxpayers have not taken full advantage of existing saving incentives.

RSAs also replace traditional IRAs and thereby eliminate taxpayers' ability to make deductible contributions. From an economic perspective, RSAs receive tax treatment generally equivalent to traditional IRAs to which deductible contributions are made.[39] However, some would argue that the upfront deduction provides a greater psychological inducement to save, and that the elimination of traditional IRAs may reduce saving by those who would have been able to make deductible contributions.

Taxpayers may convert balances under Coverdell education savings accounts and qualified tuition programs into LSAs before January 1, 2006. Under the proposal, existing balances in Coverdell education savings accounts and existing balances in qualified tuition programs (up to $50,000) may be converted to LSA balances with no income tax consequences. This means that earnings accumulated on Coverdell education savings accounts and qualified tuition program balances that are converted to LSAs may be withdrawn and spent for purposes other than education without the income tax consequences applicable to Coverdell education savings account and qualified tuition program distributions that are used for nonqualifying expenses. There is some scope for abuse of this conversion option. Conversion allows the

[38] Some argue that contributions to deductible IRAs declined substantially after 1986 for taxpayers whose eligibility to contribute to deductible IRAs was not affected by the income-related limits introduced in 1986, because financial institutions cut back on promoting contributions as a result of the general limits on deductibility. Thus, they would argue, universally available tax-preferred accounts such as LSAs and RSAs will increase saving at all income levels.

[39] Whether an RSA and a traditional IRA to which deductible contributions are made are in fact economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. When marginal rates decrease over time (because tax rates change generally or taxpayers fall into lower tax brackets), a traditional IRA to which deductible contributions are made is more advantageous than an RSA because the traditional IRA permits taxpayer to defer payment of tax until rates are lower. When marginal tax rates increase over time, an RSA is more advantageous.

consolidation of saving into a single vehicle for simplification purposes. However, a taxpayer with sufficient resources may effect such a conversion simply to shift more saving into tax-favored accounts. For example, a taxpayer could transfer $50,000 from an existing qualified tuition program into an LSA, and then reinvest a different $50,000 into the qualified tuition program.

The tax treatment of contributions under qualified retirement plans is essentially the same as that of traditional IRAs to which deductible contributions are made. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. A policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and reduces pressure on the social security system.

Some argue that offering LSAs and RSAs will reduce the incentive for small business owners to maintain qualified retirement plans for themselves and their employees. A business owner can generally contribute more to a qualified plan than the contributions that may be made to LSAs and RSAs, but only if comparable contributions are made by or on behalf of rank-and-file employees. The business owner must therefore successfully encourage rank-and-file employees to contribute to the plan or, in many cases, make matching or nonelective contributions for rank-and-file employees. The opportunity to contribute $5,000 annually to both an LSA and an RSA for both the business owner and his or her spouse, without regard to adjusted gross income or contributions for rank-and-file employees, may be a more attractive alternative to maintaining a qualified retirement plan. Others argue that many employers (including small employers) offer qualified retirement plans to attract and retain high-quality employees and will continue to do so. Some raise concerns that, as a substitute for a qualified retirement plan, an employer could selectively choose to pay additional compensation only to highly compensated employees in the form of contributions to LSAs and RSAs. This may undermine the principle of promoting savings for rank-and-file employees.

Thus, some argue that the proposal may reduce qualified retirement plan coverage, particularly in the case of small businesses. Whether any reduced coverage would result in an overall reduction of retirement security would depend, in part, on the extent to which individuals who are not covered by a qualified retirement plan instead contribute to the new savings vehicles.

Complexity

The proposal has elements that may both increase and decrease tax law complexity. On one hand, the proposal provides new savings options to individuals, which may increase complexity to the extent that taxpayers open new LSAs and RSAs without consolidating existing tax-preferred savings into such accounts. In addition, although the proposal relating to RSAs generally precludes future contributions to traditional IRAs, the proposal relating to LSAs does not preclude future contributions to present-law tax-favored arrangements for certain purposes, such as Coverdell education savings accounts, qualified tuition programs, and health savings

accounts. On the other hand, the proposal may decrease complexity by permitting consolidation of tax-favored savings accounts.

Additionally, with respect to future saving, in one respect choices are made easier by the elimination of the need to decide whether to make deductible or nondeductible IRA contributions for those taxpayers eligible to contribute to both. However, employer-sponsored qualified retirement plans generally receive the same tax treatment as traditional IRAs to which deductible contributions are made (i.e., contributions are not taxable, but distributions are). Therefore, the increased availability of Roth-type savings vehicles, in terms of eligibility to make contributions and higher contribution limits, is likely to mean that many more taxpayers will face a choice of how to balance their savings between deductible and nondeductible savings vehicles. Notwithstanding, the ability to make contributions to LSAs and RSAs without limitations based on age or income level, the uniform tax treatment of all contributions to LSAs and RSAs, and the lack of restrictions on LSA withdrawals, are likely to decrease complexity.

Prior Action

The President's fiscal year 2004 budget proposals included a similar proposal; among the differences are that in the fiscal year 2004 proposal, the annual dollar limit on contributions to RSAs or to LSAs was $7,500.

2. Consolidation of employer-based savings accounts

Present Law

In general

A plan of deferred compensation that meets the qualification standards of the Code (a qualified retirement plan) is accorded special tax treatment under present law. Employees do not include contributions in gross income until amounts are distributed, even though the arrangement is funded and benefits are nonforfeitable. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee's income. Contributions to a qualified plan (and earnings thereon) are held in a tax-exempt trust.

Qualified retirement plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (i.e., a section 401(k) plan), employees may elect to make pretax contributions to a plan. Such contributions are referred to as elective deferrals. Employees may also make after-tax contributions to a qualified retirement plan. Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to be qualified and for the favorable tax treatment to apply. These requirements include nondiscrimination rules that are intended to ensure that a qualified

retirement plan covers a broad group of employees. Certain of these rules are discussed in more detail, below.

Qualified retirement plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided. Under a defined benefit plan, benefits are determined under a plan formula, generally based on compensation and years of service. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant.

In addition to qualified section 401(k) plans, present law provides for other types of employer-sponsored plans to which pretax employee elective contributions can be made. Many of these arrangements are not qualified retirement plans, but receive the same tax-favored treatment as qualified retirement plans. The rules applicable to each type of arrangement vary. These arrangements include SIMPLE section 401(k) plans, tax-sheltered annuity plans ("section 403(b) plans"),[40] governmental eligible deferred compensation plans ("section 457 plans"),[41] SIMPLE IRAs,[42] and salary-reduction simplified employee pensions ("SARSEPs").[43]

Limits on contributions to qualified defined contribution plans

The annual additions under a defined contribution plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation ($41,000 for 2004). Annual additions are the sum of employer contributions,[44] employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Nondiscrimination requirements applicable to qualified retirement plans

The nondiscrimination requirements are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees.[45]

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[40] Sec. 403(b).

[41] Sec. 457.

[42] Sec. 408(p).

[43] Sec. 408(k).

[44] Elective deferrals are treated as employer contributions for this purpose.

[45] For purposes of the nondiscrimination requirements, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2004) or (b) at the election of the employer had compensation for the preceding year in excess of $90,000 (for 2004) and was in the top 20 percent of employees by compensation for such year (sec. 414(q)). A nonhighly compensated employee is an employee other than a highly compensated employee.

Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.[46] Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules. Under the regulations, the amount of contributions or benefits provided under the plan and the benefits, rights and features offered under the plan must be tested.[47]

Treasury regulations provide three general approaches to testing the amount of nonelective contributions provided under a defined contribution plan: (1) design-based safe harbors; (2) a general test; and (3) cross-testing.[48] Elective deferrals, matching contributions, and after-tax employee contributions are subject to separate testing as described below.

Qualified cash or deferred arrangements (section 401(k) plans)

In general

Section 401(k) plans are subject to the rules generally applicable to qualified defined contribution plans.[49] In addition, special rules apply.

As described above, an employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an individual is $13,000 for 2004.[50] An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan. As a result, the limit on elective deferrals is increased for an individual who has attained age 50 by $3,000 for 2004.[51] An employee's elective deferrals must be fully vested.

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[46] Sec. 401(a)(4). A qualified retirement plan of a State or local governmental employer is not subject to the nondiscrimination requirements.

[47] *See*, Treas. Reg. sec. 1.401(a)(4)-1.

[48] *See*, Treas. Reg. sec. 1.401(a)(4)-2(b) and (c) and sec. 1.401(a)(4)-8(b).

[49] Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

[50] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased many of the limits applicable to employer-sponsored retirement plans, generally effective for years beginning after December 31, 2001. Under EGTRRA, the dollar limit on elective deferrals increases to $14,000 for 2005 and $15,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[51] The additional amount permitted for catch-up contributions increases to $4,000 for 2005 and $5,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The catch-up contribution provisions are subject to the general sunset provision of EGTRRA.

Special nondiscrimination tests

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the "ADP" test.[52] The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a "safe harbor section 401(k) plan").[53] A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Alternatively, the matching contribution requirement is met if (1) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (2) the aggregate amount of matching contributions at such rate of employee elective deferral is at least equal to the aggregate amount of matching contributions that would be made if matching contributions were made on the basis of the percentages described in the preceding formula. A plan does not meet the contributions requirement if the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is greater than the rate of matching contribution with respect to the same rate of elective deferral of a nonhighly compensated employee.

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[52] Sec. 401(k)(3).

[53] Sec. 401(k)(12).

Nondiscrimination tests for matching contributions and after-tax employee contributions

Employer matching contributions and after-tax employee contributions are also subject to a special annual nondiscrimination test, the "ACP test".[54] The ACP test compares the actual contribution percentages ("ACPs") of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

A safe harbor section 401(k) plan is deemed to satisfy the ACP test with respect to matching contributions, provided that (1) matching contributions are not provided with respect to elective deferrals or after-tax employee contributions in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals or after-tax contributions increases, and (3) the rate of matching contribution with respect to any rate of elective deferral or after-tax employee contribution of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral or contribution of a nonhighly compensated employee.

Tax-sheltered annuities (section 403(b) plans)

Section 403(b) plans are another form of employer-based retirement plan that provide the same tax benefits as qualified retirement plans. Employers may contribute to such plans on behalf of their employees, and employees may make elective deferrals. Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools). Some of the rules that apply to section 403(b) plans are similar to rules applicable to qualified retirement plans.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals (and catch-up contributions) under a section 401(k) plan. If contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the contributions under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, additional elective deferrals are permitted under a plan maintained by an educational organization, hospital,

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[54] Sec. 401(m).

home health service agency, health and welfare service agency, church or convention of churches in the case of employees who have completed 15 years of service.

Section 403(b) plans are generally subject to the minimum coverage and general nondiscrimination rules that apply to qualified defined contribution plans. In addition, employer matching contributions and after-tax employee contributions are subject to the ACP test. However, pretax contributions made by an employee under a salary reduction agreement (i.e., contributions that are comparable to elective deferrals under a section 401(k) plan) are not subject to nondiscrimination rules similar to those applicable to section 401(k) plans. Instead, all employees generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.[55]

Eligible deferred compensation plans of State and local governments (section 457 plans)

Compensation deferred under a section 457 plan of a State or local governmental employer is includible in income when paid.[56] The maximum annual deferral under such a plan generally is the lesser of (1) $13,000 for 2004 (increasing to $15,000 by 2006) or (2) 100 percent of compensation. A special, higher limit applies for the last three years before a participant reaches normal retirement age (the "section 457 catch-up limit"). In the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of $3,000 for 2004 (increasing to $5,000 by 2006), unless a higher section 457 catch-up limit applies. Only contributions to section 457 plans are taken into account in applying these limits; contributions made to a qualified retirement plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457 plan for that employee.

SIMPLE retirement plans

Under present law, a small business that employs fewer than 100 employees can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE plan can be either an individual retirement arrangement for each employee (a "SIMPLE IRA") or part of a section 401(k) plan (a "SIMPLE section 401(k) plan").

A SIMPLE retirement plan allows employees to make elective deferrals, subject to a limit of $9,000 for 2004 (increasing to $10,000 in 2005). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE plan up to a limit of $1,500 for 2004 (increasing to $2,500 by 2006).

Employer contributions to a SIMPLE plan must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee

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[55] As in the case of a qualified retirement plan, a section 403(b) plan of a State or local governmental employer is not subject to the nondiscrimination rules.

[56] Section 457 applies also to deferred compensation plans of tax-exempt entities. Those plans are not affected by the proposal; only the rules for governmental section 457 plans are relevant for purposes of this discussion.

elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. Under a special rule applicable only to SIMPLE IRAs, the employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than two out of any five years. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a two percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan and the employer may not maintain any other plan. All contributions to an employee's SIMPLE account must be fully vested.

In the case of a SIMPLE IRA, the group of eligible employees generally must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. A SIMPLE IRA is not subject to the nondiscrimination rules generally applicable to qualified retirement plans. In the case of a SIMPLE section 401(k) plan, the group of employees eligible to participate must satisfy the minimum coverage requirements generally applicable to qualified retirement plans. A SIMPLE section 401(k) plan does not have to satisfy the ADP or ACP test and is not subject to the top-heavy rules. The other qualified retirement plan rules generally apply.

Salary reduction simplified employee pensions ("SARSEPs")

A simplified employee pension ("SEP") is an IRA to which employers may make contributions up to the limits applicable to defined contribution plans. All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee (1) has attained age 21, (2) has performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $450 (for 2004) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation. For this purpose permitted disparity may be taken into account.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP (a "SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($13,000 for 2004, increasing to $15,000 by 2006). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $1,500 for 2004 (increasing to $2,500 by 2006).

Designated Roth contributions

There are two general types of individual retirement arrangements ("IRAs") under present and prior law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-½, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to $10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).

Beginning in 2006, a section 401(k) plan or a section 403(b) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe) as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated Roth contributions. Designated Roth contributions are treated as any other elective deferral for certain purposes, including the nondiscrimination requirements applicable to section 401(k) plans.

A qualified distribution from a participant's designated Roth contributions account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

Description of Proposal

In general

Under the proposal, the various present-law employer-sponsored retirement arrangements under which individual accounts are maintained for employees and employees may make contributions are consolidated into a single type of arrangement called an employer retirement savings account (an "ERSA"). An ERSA is available to all employers and is subject to simplified qualification requirements.

Employer Retirement Savings Accounts

In general

The rules applicable to ERSAs generally follow the present-law rules for section 401(k) plans with certain modifications. Existing section 401(k) plans and thrift plans are renamed

ERSAs and continue to operate under the new rules. Existing section 403(b) plans, governmental section 457 plans, SARSEPs, and SIMPLE IRAs and SIMPLE section 401(k) plans may be renamed ERSAs and operate under the new rules. Alternatively, such arrangements may continue to be maintained in their current form, but may not accept any new employee deferrals or after-tax contributions after December 31, 2005.[57]

Types of contributions and treatment of distributions

An ERSA may provide for an employee to make pretax elective contributions and catch-up contributions up to the present-law limits applicable to a section 401(k) plan, that is, a limit of $13,000 for elective deferrals made in 2004 (increasing to $15,000 by 2006) and a limit of $3,000 for catch-up contributions in 2004 (increasing to $5,000 by 2006). An ERSA may also allow an employee to designate his or her elective contributions as Roth contributions or to make other after-tax employee contributions. An ERSA may also provide for matching contributions and nonelective contributions. Total annual contributions to an ERSA for an employee (including employee and employer contributions) may not exceed the present-law limit of the lesser of 100 percent of compensation or $41,000 (as indexed for future years).

Distributions from an ERSA of after-tax employee contributions (including Roth contributions) and qualified distributions of earnings on Roth contributions are not includible in income. All other distributions are includible in income.

Nondiscrimination requirements

The present-law ADP and ACP tests are replaced with a single nondiscrimination test. If the average contribution percentage for nonhighly compensated employees is six percent or less, the average contribution percentage for highly compensated employees cannot exceed 200 percent of the nonhighly compensated employees' average contribution percentage. If the average contribution percentage for nonhighly compensated employees exceeds six percent, the nondiscrimination test is met. For this purpose, a "contribution percentage" is calculated for each employee as the sum of employee pretax and after-tax contributions, employer matching contributions, and qualified nonelective contributions made for the employee, divided by the employee's compensation.

A design-based safe harbor is available for an ERSA to satisfy the nondiscrimination test. Similar to the section 401(k) safe harbor under present law, under the ERSA safe harbor, the plan must be designed to provide all eligible nonhighly compensated employees with either (1) a fully vested nonelective contribution of at least three percent of compensation, or (2) fully vested matching contributions of at least three percent of compensation, determined under one of two formulas. The ERSA safe harbor provides new formulas for determining required matching contributions. Under the first formula, matching contributions must be made at a rate of 50 percent of an employee's elective contributions up to six percent of the employee's compensation. Alternatively, matching contributions may be made under any other formula

[57] Special transition rules are to be provided for plans maintained pursuant to collective bargaining agreements and for plans sponsored by State and local governments.

under which the rate of matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions that would be made if matching contributions were made on the basis of the percentages described in the first formula. In addition, the rate of matching contribution with respect to any rate of elective contribution cannot be higher for a highly compensated employee than for a nonhighly compensated employee.

A plan sponsored by a State or local government is not subject to the nondiscrimination requirements. In addition, a plan sponsored by an organization exempt from tax under section 501(c)(3) is not subject to the ERSA nondiscrimination tests (unless the plan permits after-tax or matching contributions), but must permit all employees of the organization to participate.

Special rule for small employers

Under the proposal, an employer that employed 10 or fewer employees with compensation of at least $5,000 in the prior year is able to offer an ERSA in the form of custodial accounts for employees (similar to a present-law IRA), provided the employer's contributions satisfy the ERSA design-based safe harbor described above. The option of using custodial accounts under the proposal provides annual reporting relief for small employers as well as relief from most fiduciary requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") under circumstances similar to the relief provided to sponsors of SIMPLE IRAs under present law.

Effective date

The proposal is effective for years beginning after December 31, 2004, including the option of designating employee elective contributions as Roth contributions (which is effective in 2006 under present law).

Analysis

Policy and complexity issues relating to employer-sponsored retirement plans[58]

An employer's decision to establish or continue a retirement plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for certain employer-sponsored retirement plans in order to further retirement income policy by encouraging the establishment and continuance of plans that provide broad coverage, including rank-and-file employees. On the other hand, tax policy is concerned also with the level of tax subsidy provided to retirement plans. Thus, the tax law limits the total amount that may be provided to any one employee under a tax-favored retirement plan and includes strict nondiscrimination rules to prevent highly

[58] For a detailed discussion of complexity issues related to retirement savings, *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.

compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to employer-sponsored retirement plans.

The rules governing employer-sponsored retirement plans, particularly the nondiscrimination rules, are generally regarded as complex. Some have argued that this complexity deters employers from establishing qualified retirement plans or causes employers to terminate such plans. Others assert that the complexity of the rules governing employer-sponsored retirement plans is a necessary byproduct of attempts to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer and to provide employers, particularly large employers, with the flexibility needed to recognize differences in the way that employers do business and differences in workforces.

Analysis of ERSA proposal

General nondiscrimination test

The special nondiscrimination rules for 401(k) plans are designed to ensure that nonhighly compensated employees, as well as highly compensated employees, actually receive benefits under the plan. The nondiscrimination rules give employers an incentive to make the plan attractive to lower- and middle-income employees (e.g., by providing a match or qualified nonelective contributions) and to undertake efforts to enroll such employees, because the greater the participation by such employees, the more highly compensated employees can contribute to the plan.

Some argue that the present-law nondiscrimination rules are unnecessarily complex and discourage employers from maintaining retirement plans. By reducing the complexity associated with ADP and ACP testing and reducing the related compliance costs associated with a plan, the proposal arguably makes employers more likely to offer retirement plans, thus increasing coverage and participation. Others argue that the present-law section 401(k) safe harbor already provides a simplified method of satisfying the nondiscrimination requirements without the need to run the ADP and ACP tests. Some also point out that the proposal allows a greater differential in the contribution rates for highly and nonhighly compensated employees under an ERSA than the present-law rules for section 401(k) plans. They argue that this weakens the nondiscrimination rules by enabling employers to provide greater contributions to highly paid employees than under present law without a corresponding increase in contributions for rank-and-file employees. They also argue that the proposal reduces the incentive for employers to encourage nonhighly compensated employees to participate in the plan, which could result in lower contributions for rank-and-file employees. On the other hand, others believe that allowing contributions to favor highly paid employees more than under present law is appropriate in order to encourage employers to maintain plans that benefit rank-and-file employees.

ERSA safe harbor

The present-law safe harbors for elective deferrals and matching contributions were designed to achieve the same objectives as the special nondiscrimination tests for these amounts, but in a simplified manner. The alternative of a nonelective contribution of three percent ensures a minimum benefit for all employees covered by the plan, while the alternative of matching

contributions at a higher rate (up to four percent) was believed to be sufficient incentive to induce participation by nonhighly compensated employees. It was also hoped that the safe harbors would reduce the complexities associated with qualified plans, and induce more employers to adopt retirement plans for their employees.

To the extent that the ERSA safe harbor requires an employee's elective deferrals to be matched at only a 50 percent rate and requires a total of only three percent in matching contributions, some argue that the proposal not only weakens the matching contribution alternative under the safe harbor, but also makes that alternative clearly less expensive for the employer than the nonelective contribution alternative, thereby reducing the incentive for an employer to provide nonelective contributions. In addition, because, as under the present-law safe harbor, the matching contribution alternative is satisfied by offering matching contributions (without regard to the amount actually provided to nonhighly compensated employees), some argue that employers may no longer have a financial incentive to encourage employees to participate. This may reduce participation by rank-and-file employees. The argument may also be made that the matching contribution requirement under the ERSA safe harbor is less rigorous than the matching contribution requirement that applies to a SIMPLE plan under present law, even though an ERSA is not subject to the limitations on SIMPLE arrangements (i.e., contributions are subject to lower limits and SIMPLEs are available only to small employers). On the other hand, some believe that the present law safe harbor for section 401(k) plans has failed to provide an adequate incentive for employers to offer retirement plans to their employees and further incentive is needed. Some argue that the proposal makes the safe harbor more attractive for employers, especially small employers, and will thus increase coverage and participation.

Consolidation of various types of employer-sponsored plans

One of the sources of complexity in the present-law rules relating to employer-sponsored retirement plans is the existence of numerous vehicles with similar purposes but different rules.[59] Thus, employers desiring to adopt a retirement plan must determine which vehicles are available to that employer and which of the various vehicles available it wishes to adopt. This determination may entail a costly and time-consuming analysis and comparison of a number of different types of plans. By providing only one type of defined contribution plan to which employee contributions may be made, i.e., an ERSA, the proposal makes it easier for employers to determine whether to adopt a plan and what type of plan to provide. Having a single type of plan may also make it easier for employees to understand their retirement benefits, particularly when employees change jobs.

On the other hand, many employers already have plans and are familiar with the present-law rules applicable to their plans. Converting a present-law arrangement to an ERSA will

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[59] This issue is discussed in 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. *See*, Vol. II, Part III.A.1 (General simplification issues, pages 149-150), and Part III.C.5 (Sources of Complexity, page 186).

involve administrative costs, which some employers may not view as commensurate with simplification benefits.

Many view the different rules for different types of plans as largely historical in nature and as adding complexity without serving an overriding policy objective. On the other hand, some argue that the differences in the rules serve different employment objectives and policies of different types of employers.

Some may be concerned that the proposal, in combination with the proposals for expanded individual savings opportunities (i.e., Lifetime Savings Accounts and Retirement Savings Accounts), will further reduce the incentive for small employers to offer retirement plans to their employees.[60] Although higher contributions may be made to an employer-sponsored retirement plan than to these other arrangements, comparable contributions must be made by or on behalf of rank-and-file employees. The opportunity to contribute $5,000 a year to both a Lifetime Savings Account and a Retirement Savings Account for both the business owner and his or her spouse, without regard to adjusted gross income or contributions for rank-and-file employees, may be a more attractive alternative to maintaining a qualified retirement plan. On the other hand, the excludability of ERSA contributions and the availability of the ERSA safe harbor, coupled with the higher contribution levels permitted under a qualified plan, may be viewed as providing an adequate incentive for a small employer to establish an ERSA.

Prior Action

The President's fiscal year 2004 budget proposal included a similar proposal. In addition, the President's fiscal year 2004 budget included several proposals to simplify the rules for defined contribution plans generally.

3. 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.[61] 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'

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[60] The proposals relating to Lifetime Savings Accounts and Retirement Savings Accounts are discussed in Part II.A.1 of this document.

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

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 provides a nonrefundable tax credit for a qualified entity (i.e., qualified financial institutions, qualified nonprofit organizations and qualified Indian tribes) that has an individual development account program in a taxable year. The tax credit equals the amount of matching contributions made by the eligible entity under the program (up to $500 per account 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 is available only for accounts with a balance of more than $100 at year-end. The amount of the credit is adjusted for inflation after 2005. 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 is available with respect to the amount of matching funds taken into account in determining the credit.

The credit applies with respect to the first 900,000 individual development accounts opened before January 1, 2010, and with respect to matching funds for participant contributions that are made after December 31, 2004, and before January 1, 2012.

Nonstudent U.S. citizens or legal residents between the ages of 18 and 60 (inclusive) who are not dependents of a taxpayer and who meet certain income requirements are eligible to open and contribute to an individual development account. The income limit is modified adjusted gross income of $20,000 for single filers, $40,000 for joint filers, and $30,000 for head-of-household filers.[62] Eligibility in a taxable year is based on the previous year's modified adjusted gross income and circumstances (e.g., status as a student). Modified adjusted gross income is 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 are adjusted for inflation after 2005. 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 is required to maintain separate accounts for the individual's contributions (and earnings therein) and matching funds and earnings thereon.

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

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

The proposal permits individuals to withdraw amounts from an individual development account for qualified expenses of the account owner, owner's spouse, or dependents. Withdrawals other than for qualified expenses ("nonqualified" withdrawals) may not be made from the portion of the accounts attributable to the matching contributions before the account owner attains age 61. In addition, nonqualified withdrawals from the portion of the account attributable to the individual contributions may result in forfeiture of some or all of the amounts attributable to matching contributions. 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 home and business capitalization expenses must be paid directly to another financial institution. Withdrawals for qualified educational expenses must be paid directly to the educational institution. Such withdrawals generally are not permitted until the account owner completes a financial education course offered by a qualified financial institution, qualified nonprofit organization, qualified Indian tribe or governmental entity. The Secretary of the Treasury (the "Secretary") is 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 is generally 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 is adjusted for inflation after 2005. Matching funds may be provided also by State, local, or private sources. Balances of the individual development account and parallel account are reported annually to the account owner. If an account owner ceases to meet eligibility requirements, matching funds generally are not contributed during the period of ineligibility. Any amount withdrawn from a parallel account is not includible in an eligible individual's gross income or the account sponsor's gross income.

Qualified entities administering a qualified program are required to report to the Secretary that the program is administered in accordance with legal requirements. If the Secretary determines that the program is not so operated, the Secretary has the power to terminate the program. Qualified entities also are 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 is authorized to prescribe necessary regulations, including rules to permit individual development account program sponsors to verify eligibility of individuals seeking to

open accounts. The Secretary is also authorized to provide rules to recapture credits claimed with respect to individuals who forfeit matching funds.

Effective date.–The proposal is effective for taxable years ending after December 31, 2004, and beginning before January 1, 2012.

Analysis

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 applies creates the potential for unequal tax treatment of similarly situated individuals, and may effectively allow financial and other eligible institutions to pick and choose among potential beneficiaries of the individual development account program. Additionally, individuals without ready access to eligible institutions are disadvantaged with respect to the ability to benefit under the proposal.

Complexity issues

In general, adding a new credit to the tax law will tend to increase the complexity of the tax law and will require additional Treasury or other Governmental resources to be devoted to administration of the provisions and to enforcement activities. The individual development account proposal requires 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 will increase the paperwork burden on individuals and financial institutions utilizing the provision. Arguably, the proposal will also add complexity in that it will increase the number of savings incentives in the tax law, each with different requirements. Some might argue that consolidation of these incentives will serve to simplify tax law and tax administration.

Prior Action

Similar proposals were included in the President's fiscal year 2002, 2003, and 2004 budget proposals.

B. Health Care Provisions

1. Refundable tax credit for the purchase of health insurance

Present Law

Present law contains a number of provisions dealing with the Federal tax treatment of health expenses and health insurance coverage. 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.

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[63] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care.[64] If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan is also excludable from an employee's gross income and wages.[65]

Present law provides for two general employer-provided arrangements that can be used to pay for or reimburse medical expenses of employees on a tax-favored basis: flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs"). While these arrangements provide similar tax benefits (i.e., the amounts paid under the arrangements for medical care are excludable from gross income and wages for employment tax purposes), they are subject to different rules. A main distinguishing feature between the two arrangements is that while FSAs are generally part of a cafeteria plan and contributions to FSAs are made on a salary reduction basis, HRAs cannot be part of a cafeteria plan and contributions cannot be made on a salary-reduction basis.[66]

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or

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[63] Secs. 106, 3121(a)(2), and 3306(b)(2).

[64] Sec. 105. In the case of a self-insured medical reimbursement arrangement, the exclusion applies to highly compensated employees only if certain nondiscrimination rules are satisfied. Sec. 105(h). Medical care is defined as under section 213(d) and generally includes amounts paid for qualified long-term care insurance and services.

[65] Secs. 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

[66] Notice 2002-45, 2002-28 I.R.B. 93 (July 15, 2002); Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (July 15, 2002).

partners in a partnership)[67] are entitled to deduct 100 percent of the amount paid for health insurance for themselves and their spouse and dependents for income tax purposes.[68]

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year (to the extent not reimbursed by insurance or otherwise) for medical care of the taxpayer, the taxpayer's spouse, and dependents, to the extent that the total of such expenses exceeds 7.5 percent of the taxpayer's adjusted gross income.[69]

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.[70]

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.

Under the Trade Adjustment Assistance Reform Act of 2002,[71] eligible individuals can receive a refundable tax credit for the cost of qualified health coverage. The credit is equal to 65 percent of the amount paid by certain individuals receiving a trade readjustment allowance, or who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits, or by certain individuals who are receiving pension benefits from the Pension Benefit Guaranty Corporation. The credit is payable on an advance basis.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003[72] added provisions for health savings accounts (HSAs), effective for taxable years beginning after

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[67] 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.

[68] Sec. 162(l). The deduction does not apply for self-employment tax (SECA) purposes.

[69] Sec. 213. The adjusted gross income percentage is 10 percent for purposes of the alternative minimum tax. Sec. 56(b)(1)(B).

[70] After 2003, no new contributions can 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.

[71] Pub. L. No. 107-210, sec. 201(a), 202 and 203 (2002).

[72] Pub. L. No. 108-173.

December 31, 2003. Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Eligible individuals are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent, unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Description of Proposal

The proposal provides 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 is 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 are indexed in accordance with the medical care component of the Consumer Price Index based on all-urban consumers. Thus, the maximum annual credit prior to any indexing of the premium limits is $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 is 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 are eligible for the maximum credit rate of 90 percent. The credit percentage for individuals filing a single return with no dependents is 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 are eligible for the maximum credit rate of 90 percent. The credit percentage is 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 are not allowed to make contributions to an HSA or an Archer MSA for the year the credit is claimed. Additionally, taxpayers claiming the credit are not eligible for the deduction for high deductible health plan premiums included in the President's fiscal year 2005 budget proposal.

The credit can 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 will 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 will be reimbursed by the Department of the Treasury for the amount of the credit. Eligibility for the advanced credit option is based on the individual's prior year return and there is no reconciliation on the current year return.

Policies eligible for the credit have to meet certain requirements, including coverage for high medical expenses.[73] Qualifying health insurance can 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, 2005, the credit can 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 can provide additional contributions to individuals who purchase insurance through such purchasing groups. The maximum State contribution is $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 is phased-down ratably, reaching $500 per adult at 200 percent of the poverty level. Individuals with income above 200 percent of the poverty level are not eligible for a State contribution. States are not allowed to offer any other explicit or implicit cross subsidies.

Effective date.–The credit is effective for taxable years beginning after December 31, 2004. The advanced payment option is available beginning July 1, 2006.

Analysis

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 is not 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 to benefit 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

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

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 argue that providing a credit for the purchase of health insurance undermines 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 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 potential users of the credit, 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 is not 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 can 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 are not eligible to receive the credit on the advanced basis and in many cases, because of their decreased income, will remain uninsured.

Some argue 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 is not 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 to the intended target population.

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. Taxpayers covered by high-deductibles plans that are not part of a public or employer-provided plan will need to calculate their tax liability twice to determine whether the proposed credit exceeds the value of the alternative premium deduction (as provided in the President's fiscal year 2005 budget proposal) and the present-law deduction for contributions to an HSA.

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.

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

Substantially similar proposals were included in the President's fiscal year 2002, 2003, and 2004 budget proposals.

2. Provide an above-the-line deduction for certain high deductible insurance premiums

Present Law

Tax treatment of health insurance premiums

Under present law, the tax treatment of health insurance expenses depends on an individual's circumstances.

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[74] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan or through a health reimbursement account ("HRA")[75] is also excludable from an employee's gross income and wages.[76]

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[74] Secs. 106, 3121(a)(2), and 3306(b)(2).

[75] An HRA is an arrangement that (1) is paid for solely by the employer and not provided pursuant to a salary reduction election or otherwise under a cafeteria plan; (2) reimburses the employee for medical expenses incurred by the employee and the employee's spouse and dependents; and (3) provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of the coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods. Notice 2002-45, 2002-28 I.R.B. 93.

[76] Secs. 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership)[77] are entitled to deduct 100 percent of the amount paid for health insurance for themselves and their spouse and dependents for income tax purposes.[78]

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year for health insurance (to the extent not reimbursed by insurance or otherwise) for the taxpayer, the taxpayer's spouse, and dependents, only to the extent that the taxpayer's total medical expenses, including health insurance premiums, exceeds 7.5 percent of the taxpayer's adjusted gross income.[79]

Under the Trade Adjustment Assistance Reform Act of 2002,[80] eligible individuals can receive a refundable tax credit for the cost of qualified health coverage. The credit is equal to 65 percent of the amount paid by certain individuals receiving a trade readjustment allowance, or who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits, or by certain individuals who are receiving pension benefits from the Pension Benefit Guaranty Corporation.[81] The credit is payable on an advance basis.

Reimbursements under a health insurance policy for medical expenses are generally excludable from gross income regardless of whether the insurance is purchased by the individual or employer-provided. In the case of a self-insured medical reimbursement plan, reimbursements are excludable for highly compensated employees only if certain nondiscrimination rules are satisfied.

Health savings accounts

In general

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003[82] added provisions for health savings accounts ("HSAs"), effective for taxable years beginning after

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[77] 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.

[78] Sec. 162(l). The deduction does not apply for self-employment tax (SECA) purposes.

[79] Sec. 213. The adjusted gross income percentage is 10 percent for purposes of the alternative minimum tax. Sec. 56(b)(1)(B).

[80] Pub. L. No. 107-210, sec. 201(a), 202 and 203 (2002).

[81] Amounts taken into account in determining the credit are not treated as expenses paid for medical care under sections 162(l) or 213.

[82] Pub. L. No. 108-173.

December 31, 2003. In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses.

Eligible individuals

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan and which provides coverage for any benefit which is covered under the high deductible health plan. Individuals entitled to benefits under Medicare are not eligible to make contributions to an HSA. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return. An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage.[83]

A high deductible health plan is a health plan that has a deductible that is at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit that is no more than $5,000 in the case of self-only coverage and $10,000 in the case of family coverage.[84] A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

Tax treatment of and limits on contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an Archer MSA high deductible health plan under present law, as adjusted for inflation. For 2004, the amount of the maximum deductible under an Archer MSA high deductible health plan is $2,600 in the case of self-only coverage and $5,150 in the case of family coverage. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise

[83] Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

[84] The limits are indexed for inflation.

applicable limit by $500 in 2004, $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. Qualified medical expenses generally are defined as under section 213(d). Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums for Medicare, other than premiums for Medigap policies. Such qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under section 213. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income are also subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Other provisions

Present law also provides other tax benefits for medical expenses other than health insurance. For example, a flexible spending arrangement ("FSA") is defined under the Code as a benefit program which provides employees with coverage under which specified incurred expenses may be reimbursed and the maximum amount of reimbursement which is reasonably available to a participant for such coverage is less than 500 percent of the value of such coverage.[85] A health FSA is an FSA that provides for reimbursement of medical expenses. Health FSAs are typically part of a cafeteria plan and may be funded through salary reduction. Health FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance, but can not be used for health insurance. There is no special exclusion for benefits provided under an FSA. Thus, health benefits provided under an FSA are excludable from income only if they qualify for exclusion under sections 105 or 106.

[85] Sec. 106(c).

Description of Proposal

The proposal provides an above-the-line deduction for high deductible health insurance premiums for individuals who contribute to an HSA. As under the present-law rules relating to HSA eligibility, an individual does not qualify for the deduction if the individual is covered by any health plan other than the high deductible plan for which the deduction is claimed, except for certain permitted coverage. The deduction is only allowed for insurance purchased in the individual insurance market and is not allowed for individuals covered by employer plans or public plans. Additionally, the deduction is not allowed to an individual claiming the refundable tax credit for the purchase of health insurance included in the President's fiscal year 2005 budget proposal.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Policy issues

The proposal is intended to provide an incentive for individuals to purchase high deductible health plans in connection with the use of HSAs. Allowing a deduction for premiums of high deductible health plans provides a subsidy for the purchase of such plans, thus making them more affordable. The proposal raises both health policy issues and tax policy issues.

Proponents believe that the use of high deductible health plans promotes responsible health policy. Proponents argue that the use of high deductible health plans (together with HSAs) will encourage cost consciousness and result in better decision-making with respect to health care expenses because such plans make individuals more aware of their health care expenses.

Critics argue that it is inappropriate to favor high deductible health plans. Critics argue that providing a preference for the purchase of high deductible health insurance purchased in the individual market undermines the current group-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. Critics also argue that any cost reductions hoped for due to the use of high deductible health plans are undermined by the availability of HSAs.

Critics have concerns with favoring any insurance purchased in the individual market. Some argue that favoring plans purchased in the individual market and excluding employer plans, may even cause some employers to not offer health benefits for their employees if they feel that significant tax incentives exist in the individual market. Critics argue that 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. Critics argue that individuals who are unable to obtain coverage in the individual market will be greatly disadvantaged by the proposal. Critics are also concerned about the focus of the deduction on insurance purchased in the individual market because they believe the individual market does not presently offer

sufficient protections to purchasers, and that any tax incentive for the purchase of coverage in the individual market should only be adopted if accompanied by reforms (e.g., guaranteed issue).

Some argue that the tax laws should not provide a subsidy only for one particular type of plan, because a targeted subsidy inappropriately causes tax considerations to enter into the choice of insurance. Those who hold this view include some who view high deductible insurance as preferable from a health policy perspective, but who believe the tax laws should be neutral with respect to economic choices.

Proponents also argue that the proposal will reduce the number of uninsured individuals. Many uninsured individuals may purchase high deductible health plans given the tax advantages of HSAs and the deduction under the proposal. Others argue that because the proposal is limited to a certain type of plan, it may have a minimal effect on reducing the number of uninsured. Some may argue that those who are uninsured because they cannot afford coverage still may not have sufficient resources to afford a high deductible plan even on a tax-subsidized basis. Other younger healthier uninsured individuals who can afford health insurance may choose to continue to remain uninsured even with the tax incentive.

Some 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 the rising cost of health care and number of uninsured individuals. On the other hand, some point out that Congress has already provided subsidies to high deductible health plans through the tax law (i.e., HSAs) to encourage people to use such plans and save for health expenses, and that this proposal is consistent with the policy already expressed by Congress.

Proponents argue that the proposal will reduce the inequities under present law regarding the tax treatment of health insurance expenses. Proponents argue that providing a deduction for high deductible health plans will level the playing field for those who are not self-employed or do not have employer-provided coverage. While the proposal addresses some of the present-law differences in the tax treatment between employer-subsidized health insurance and insurance purchased by individuals, critics argue that it is not appropriate for a tax subsidy for the purchase of insurance to be limited to one particular type of plan. Critics argue that limiting the subsidy to high deductible health plans will further contribute to the inequitable tax treatment of health expenses and may actually increase inequities by providing, in connection with HSAs, a very generous subsidy for one particular type of plan.

Some argue that the present-law differences in the tax treatment between employer-subsidized health insurance and insurance purchased by individuals could be more equitably addressed by limiting the exclusion for employer-provided health coverage. Others question whether an exclusion for employer-provided health expenses should exist, as such preference leads to a tax system which is not neutral with respect to similar expenses. Some argue that a tax preference should exist only to the extent extraordinary medical expenses affect an individual's ability to pay and that this is already sufficiently addressed with the present-law itemized deduction (to the extent of 7.5 percent of adjusted gross income) for medical expenses.

Even if one agrees that high deductible health plans are preferable from a health policy perspective and should be tax-favored, some argue that inequities will result because the

proposal is narrowly targeted. For example, because the proposal is limited to insurance purchased in the individual market, an individual participating in a group high-deductible plan could not qualify for the deduction even if the employee pays 100 percent of the cost of coverage.

While the proposal provides that the deduction is not allowed for individuals covered by employer plans, it is unclear what specifically constitutes an employer plan. For example, an employee could have a high deductible health plan purchased in the individual market, a portion of the cost of which is paid by the employer. It is unclear whether such plan would qualify for the deduction.

Complexity issues

Conditioning the deduction on making a contribution to an HSA adds complexity to the proposal compared to providing a deduction without such a requirement. In addition, the requirement is easily satisfied, raising questions as to whether the additional complexity serves any policy function. For example, an individual could contribute as little as $1 to an HSA and be eligible for the deduction.

By providing additional options to individuals, the proposal may increase transactional complexity because individuals will have to determine which option is best for them. Individuals eligible for the proposed refundable tax credit for health insurance will have to determine which option is best for them because such individuals are not eligible for both the credit and the deduction. Employees will also have to determine whether it is better to remain in employer plans or to purchase a policy in the individual market.

In order for the IRS to administer the deduction, additional reporting would need to be required. To determine if individuals are eligible for the deduction, policyholders would have to be notified whether their health insurance plan qualifies. Providers of high deductible health plans would need to provide information regarding the type of health insurance plan, such as the policy premium and deductible and that the policy meets the requirements for the deduction.

Creating a new tax deduction will necessitate a new line on the Form 1040 and additional information in instructions regarding the deduction. The new deduction may also require IRS programming modifications.

Prior Action

No prior action.

3. Provide an 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. 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.[86] 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 2004): $260 in the case of an individual 40 years old or less; $490 in the case of an individual who is more than 40 but not more than 50; $980 in the case of an individual who is more than 50 but not more than 60; $2,600 in the case of an individual who is more than 60 but not more than 70; and $3,250 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Self-employed individuals may deduct qualified long-term care insurance premiums for the individual and his or her spouse and dependents.[87] 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 that applies 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 only insurance protection provided under the contract can be coverage for qualified long-term care services; (2) the contract must not pay or reimburse expenses reimbursable under Medicare or application of a deductible or coinsurance amount; (3) the contract must be guaranteed renewable; (4) the contract generally cannot provide for a cash surrender value or other money that can be paid, assigned, or pledged as a loan or borrowed; (5) 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 (6) the contract must meet certain consumer protection standards.[88] 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 (NAIC); (2) the issuer of the contract discloses that the contract is intended to be

[86] Sec. 213(d).

[87] 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.

[88] Sec. 7702B.

a qualified policy; and (3) the issuer offers the policyholder a nonforfeiture provision meeting certain requirements.

Description of Proposal

The proposal provides an above-the-line deduction for a percentage of qualified long-term care insurance premiums up to the dollar limitations that apply under the present-law itemized deduction. The deduction is available to an individual covered under an employer-sponsored health plan if the employee pays at least 50 percent of the cost of the coverage. The Secretary is authorized to require qualified long-term care insurance policies to meet consumer protection standards for quality coverage, for example, to reflect changes in the NAIC model standards.

The deductible percentage of qualified long-term care insurance premiums is 25 percent in 2005, 35 percent in 2006, 65 percent in 2007, and 100 percent in 2008 and thereafter.

Effective date.–The proposal is effective for taxable years beginning on or after January 1, 2005.

Analysis

Policy issues

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.[89] 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 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 provides 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

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

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 2005 budget proposal contains other provisions, in particular, a tax credit for the purchase of health insurance and an above-the-line deduction for high deductible health insurance premiums, 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.

Many agree that it is important to impose standards on long-term care insurance policies to ensure that products deliver quality to consumers. While the proposal provides that the Secretary is authorized to require qualified long-term care insurance policies to meet consumer protection standards for quality coverage, it does not mandate standards. Some argue that standards should be mandatory and that should be should specifically enumerated in the law. Lack of specific standards provides uncertainty in determining whether a specific product qualifies for the deduction. Others argue that it is important to provide the Secretary flexibility in imposing such requirements.

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 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 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 also adds complexity in that it would increase the number of savings incentives in the tax law, each with different requirements.

A new tax deduction will increase complexity in IRS forms and instructions, by requiring a new line on the Form 1040 and additional information in instructions regarding the deduction. The new deduction may also require IRS programming modifications.

Prior Action

Substantially similar proposals were included in the President's fiscal year 2002, 2003, and 2004 budget proposals and in the Taxpayer Refund and Relief Act of 1999 as passed by the 106th Congress and vetoed by the President.

4. 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 ($3,050 for 2003) 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 ($3,050 in 2003) 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 allows 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 is 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.

Qualified family members include an individual with long-term care needs who: (1) is the taxpayer's spouse or an ancestor of the taxpayer (or, if married an ancestor of the taxpayer's spouse); and (2) is a member of the taxpayer's household for the entire taxable year.

An individual is 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 are eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance includes both hands-on assistance (that is, the physical assistance of another person without which the individual is 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 two-ADL test described above, an individual is considered to have long-term care needs if he or she were certified by a licensed physician as, for at least 180 consecutive days: (1) requiring substantial supervision to be protected from threats to health and safety due to severe cognitive impairment and (2) 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 is 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 is subject to the mathematical error rule. Under that rule, the IRS may summarily assess additional 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.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Complexity issues

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

The proposal adds 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.

The proposal also adds a maintenance of household requirement to a personal exemption provision that is not a requirement under the present-law dependency exemption in many cases. For some taxpayers, this may require recordkeeping in addition to that required under present law.

Policy issues

The proposal is intended to provide a benefit to individuals who maintain a household that includes certain family members with long-term care needs. Proponents 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. The proposal is intended to recognize both the formal and informal costs of providing long-term care in the home.

On the other hand, some argue that present law already provides an appropriate level of benefits for dependents, including those with long-term care needs. For example, present law provides for an itemized deduction for long-term care expenses and other medical expenses of the taxpayer in excess of a floor. In addition, to the extent a caregiver of a person with long-term care needs incurs expenses in order to work, the caregiver may be eligible for the dependent care credit.

Prior Action

Similar proposals were included in the President's fiscal year 2002, 2003, and 2004 budget proposals.

5. Expand human clinical trials expenses qualifying for the orphan drug tax credit

Present Law

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

Description of Proposal

The proposal expands qualifying expenses to include those expenses related to human clinical testing paid or incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder, if certain conditions are met. Under the proposal, qualifying expenses include those expenses paid or incurred after the date on which the taxpayer files an application with the FDA for designation as a potential treatment for a rare disease or disorder if the drug receives FDS designation before the due date (including extensions) for filing the tax return for the taxable year in which the application was filed with the FDA. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

Effective date.–The provision is effective for expenditures paid or incurred after December 31, 2003.

Analysis

Approval for human clinical testing and designation as a potential treatment for a rare disease or disorder require separate reviews within the FDA. As a result, in some cases, a taxpayer may be permitted to begin human clinical testing prior to a drug being designated as a potential treatment for a rare disease or disorder. If the taxpayer delays human clinical testing in order to obtain the benefits of the orphan drug tax credit, which currently may be claimed only for expenses incurred after the drug is designated as a potential treatment for a rare disease or

disorder, valuable time will have been lost and Congress's original intent in enacting the orphan drug tax credit will have been partially thwarted.

For those cases where the process of filing an application and receiving designation as a potential treatment for a rare disease or disorder occurs sufficiently expeditiously to fall entirely within the taxpayer's taxable year plus permitted filing extension, the proposal removes the potential financial benefit from delaying clinical testing. While such an outcome may well describe most applications, in some cases, particularly for applications filed near the close of a taxpayer's taxable year, there may be some uncertainty that designation will be made in a timely manner. In such a case, the taxpayer is in the same position as present law and may choose to delay filing the appropriate application until the beginning of his next taxable year.

The FDA is required to approve drugs for human clinical testing. Such approval creates a unique starting point from which human clinical testing expenses can be measured. An alternative proposal would be to expand qualifying expenses to include those expenses paid or incurred after the date on which the taxpayer files an application with FDA for designation of the drug as a potential treatment for a rare disease or disorder, regardless of whether the designation is approved during the taxable year in which the application is filed. Such an alternative proposal would provide more certainty to the taxpayer regarding clinical expenses eligible for the credit. However, unlike the current proposal, such an alternative may create the additional taxpayer burden of requiring the taxpayer to file an amended return to claim credit for qualifying costs related to expenses incurred in a taxable year prior to designation.

The staff of the Joint Committee on Taxation recommended a change similar to the current proposal as part of its 2001 simplification study.[90]

Prior Action

A similar proposal was part of the President's fiscal year 2004 budget proposal.

A similar provision was included in H.R. 1308 as passed by the House of Representatives in 2003.

6. Clarifications to the refundable credit for health insurance costs of eligible individuals

Present Law

Refundable health insurance credit: in general

Under the Trade Act of 2002,[91] in the case of taxpayers who are eligible individuals, a refundable tax credit is provided for 65 percent of the taxpayer's expenses for qualified health

[90] 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, Vol. II* (JCS-3-01), April 2001, p. 310.

[91] Pub. L. No. 107-210.

insurance of the taxpayer and qualifying family members for each eligible coverage month beginning in the taxable year. The credit is available only with respect to amounts paid by the taxpayer.

Qualifying family members are the taxpayer's spouse and any dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency exemption. Any individual who has other specified coverage is not a qualifying family member.

Persons eligible for the credit

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if, as of the first day of the month, the taxpayer (1) is an eligible individual, (2) is covered by qualified health insurance, (3) does not have other specified coverage, and (4) is not imprisoned under Federal, State, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements. An eligible month must begin after November 4, 2002.[92]

An eligible individual is an individual who is (1) an eligible TAA recipient, (2) an eligible alternative TAA recipient, and (3) an eligible PBGC pension recipient.

An individual is an eligible TAA recipient during any month if the individual (1) is receiving for any day of such month a trade adjustment allowance[93] or who would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment benefits before being eligible to receive an allowance and (2) with respect to such allowance, is covered under a certification issued under subchapter A or D of chapter 2 of title II of the Trade Act of 1974. An individual is treated as an eligible TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is an eligible alternative TAA recipient during any month if the individual (1) is a worker described in section 246(a)(3)(B) of the Trade Act of 1974 who is participating in the program established under section 246(a)(1) of such Act, and (2) is receiving a benefit for such month under section 246(a)(2) of such Act. An individual is treated as an eligible alternative TAA recipient during the first month that such individual would otherwise cease to be an eligible TAA recipient.

An individual is a PBGC pension recipient for any month if he or she (1) is age 55 or over as of the first day of the month, and (2) is receiving a benefit any portion of which is paid by the Pension Benefit Guaranty Corporation (the "PBGC"). The IRS has interpreted the definition of PBGC pension recipient to also include certain alternative recipients and recipients who have received certain lump-sum payments on or after August 6, 2002.

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[92] This date is 90 days after the date of enactment of the Trade Act of 2002, which was August 6, 2002.

[93] Part I of subchapter B, or subchapter D, of chapter 2 of title II of the Trade Act of 1974.

An otherwise eligible taxpayer is not eligible for the credit for a month if, as of the first day of the month the individual has other specified coverage. Other specified coverage is (1) coverage under any insurance which constitutes medical care (except for insurance substantially all of the coverage of which is for excepted benefits)[94] maintained by an employer (or former employer) if at least 50 percent of the cost of the coverage is paid by an employer[95] (or former employer) of the individual or his or her spouse or (2) coverage under certain governmental health programs.[96] A rule aggregating plans of the same employer applies in determining whether the employer pays at least 50 percent of the cost of coverage. A person is not an eligible individual if he or she may be claimed as a dependent on another person's tax return. A special rule applies with respect to alternative TAA recipients. For eligible alternative TAA recipients, an individual has other specified coverage if the individual is (1) eligible for coverage under any qualified health insurance (other than coverage under a COBRA continuation provision, State-based continuation coverage, or coverage through certain State arrangements) under which at least 50 percent of the cost of coverage is paid or incurred by an employer of the taxpayer or the taxpayer's spouse or (2) covered under any such qualified health insurance under which any portion of the cost of coverage is paid or incurred by an employer of the taxpayer or the taxpayer's spouse.

Qualified health insurance

Qualified health insurance eligible for the credit is: (1) COBRA continuation coverage; (2) State-based continuation coverage provided by the State under a State law that requires such coverage; (3) coverage offered through a qualified State high risk pool; (4) coverage under a

[94] Excepted benefits are: (1) coverage only for accident or disability income or any combination thereof; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) worker's compensation or similar insurance; (5) automobile medical payment insurance; (6) credit-only insurance; (7) coverage for on-site medical clinics; (8) other insurance coverage similar to the coverages in (1)-(7) specified in regulations under which benefits for medical care are secondary or incidental to other insurance benefits; (9) limited scope dental or vision benefits; (10) benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof; and (11) other benefits similar to those in (9) and (10) as specified in regulations; (12) coverage only for a specified disease or illness; (13) hospital indemnity or other fixed indemnity insurance; and (14) Medicare supplemental insurance.

[95] An amount is considered paid by the employer if it is excludable from income. Thus, for example, amounts paid for health coverage on a salary reduction basis under an employer plan are considered paid by the employer.

[96] Specifically, an individual is not eligible for the credit if, as of the first day of the month, the individual is (1) entitled to benefits under Medicare Part A, enrolled in Medicare Part B, or enrolled in Medicaid or SCHIP, (2) enrolled in a health benefits plan under the Federal Employees Health Benefit Plan, or (3) entitled to receive benefits under chapter 55 of title 10 of the United States Code (relating to military personnel). An individual is not considered to be enrolled in Medicaid solely by reason of receiving immunizations.

health insurance program offered to State employees or a comparable program; (5) coverage through an arrangement entered into by a State and a group health plan, an issuer of health insurance coverage, an administrator, or an employer; (6) coverage offered through a State arrangement with a private sector health care coverage purchasing pool; (7) coverage under a State-operated health plan that does not receive any Federal financial participation; (8) coverage under a group health plan that is available through the employment of the eligible individual's spouse; and (9) coverage under individual health insurance if the eligible individual was covered under individual health insurance during the entire 30-day period that ends on the date the individual became separated from the employment which qualified the individual for the TAA allowance, the benefit for an eligible alternative TAA recipient, or a pension benefit from the PBGC, whichever applies.[97]

Qualified health insurance does not include any State-based coverage (i.e., coverage described in (2)-(8) in the preceding paragraph), unless the State has elected to have such coverage treated as qualified health insurance and such coverage meets certain requirements.[98] Such State coverage must provide that each qualifying individual is guaranteed enrollment if the individual pays the premium for enrollment or provides a qualified health insurance costs eligibility certificate and pays the remainder of the premium. In addition, the State-based coverage cannot impose any pre-existing condition limitation with respect to qualifying individuals. State-based coverage cannot require a qualifying individual to pay a premium or contribution that is greater than the premium or contribution for a similarly situated individual who is not a qualified individual. Finally, benefits under the State-based coverage must be the same as (or substantially similar to) benefits provided to similarly situated individuals who are not qualifying individuals. A qualifying individual is an eligible individual who seeks to enroll in the State-based coverage and who has aggregate periods of creditable coverage[99] of three months or longer, does not have other specified coverage, and who is not imprisoned. A qualifying individual also includes qualified family members of such an eligible individual.

Qualified health insurance does not include coverage under a flexible spending or similar arrangement or any insurance if substantially all of the coverage is of excepted benefits.

Other rules

Amounts taken into account in determining the credit may not be taken into account in determining the amount allowable under the itemized deduction for medical expenses or the deduction for health insurance expenses of self-employed individuals. Amounts distributed from

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[97] For this purpose, "individual health insurance" means any insurance which constitutes medical care offered to individuals other than in connection with a group health plan. Such term does not include Federal- or State-based health insurance coverage.

[98] For guidance on how a State elects a health program to be qualified health insurance for purposes of the credit, see Rev. Proc. 2004-12, 2004-9 I.R.B. 1.

[99] Creditable coverage is determined under the Health Care Portability and Accountability Act (Code sec. 9801(c)).

a medical savings account or health savings account are not eligible for the credit. The amount of the credit available through filing a tax return is reduced by any credit received on an advance basis. Married taxpayers filing separate returns are eligible for the credit; however, if both spouses are eligible individuals and the spouses file a separate return, then the spouse of the taxpayer is not a qualifying family member.

The Secretary of the Treasury is authorized to prescribe such regulations and other guidance as may be necessary or appropriate to carry out the provision.

Advance payment of refundable health insurance credit; reporting requirements

The credit is payable on an advance basis (i.e., prior to the filing of the taxpayer's return). The disclosure of return information of certified individuals to providers of health insurance information is permitted to the extent necessary to carry out the advance payment mechanism. The Code does not specify the items of return information that are to be disclosed, nor does it provide for the disclosure of such information to contractors of the health insurance providers authorized to receive such information. Advance payment of the credit has been available since August 1, 2003. To the extent that disclosures to persons not authorized under the statute are necessary a consent mechanism has been employed. The signature block of the registration form for the credit states "By signing, I also agree to allow the IRS to share my eligibility status and payment information with my health plan administrator." Applicants are required to give such consent in applying for the credit.

Any person who receives payments during a calendar year for qualified health insurance and claims a reimbursement for an advance credit amount is required to file an information return with respect to each individual from whom such payments were received or for whom such a reimbursement is claimed.

Description of Proposal

The President's proposal modifies the refundable health tax credit in several ways. Under the proposal, individuals who elect to receive one-time lump sum payments from the PBGC and certain alternative PBGC payees are eligible for the credit.

The proposal provides that the Commonwealths of Puerto Rico and the Northern Mariana Islands, American Samoa, Guam, and the U.S. Virgin islands are deemed to be States for purposes of the State-based coverage rules.

In addition, the proposal allows disclosure of certain information necessary to carry out the advance payment program to contractors of providers of health insurance and provides that providers of health insurance include employers and administrators of health plans.

Additionally, under the proposal, State continuation coverage provided under State law automatically qualifies as qualified health insurance, as Federally-mandated COBRA continuation coverage, without having to meet the requirements relating to State-based qualified coverage.

The proposal also changes the definition of other specified coverage for eligible alternative TAA recipients by removing the special rule that applies only to alternative TAA recipients.

Effective date.–The proposal is effective as if included in the Trade Act of 2002.

Analysis

In general

The credit was enacted to assist certain individuals in paying for qualified health insurance. The various aspects of the proposal will make the credit available to more individuals. Some aspects of the proposal may be considered clarifications of present law based on current IRS administrative positions.

Eligible individuals

While the IRS has interpreted the credit as applying to individuals who receive a one-time lump sum from the PBGC and certain alternative PBGC payees, clarifying statutorily that such individuals are eligible individuals will simplify administration of the credit. Many believe that individuals who receive a single-sum pension payment in lieu of an annuity should not be ineligible for the credit simply because they are not receiving payments on a monthly basis. In general, lump-sum payments are only received if the value of the benefit is $5,000 or less. Given the relatively small amount of the payments, most agree that requiring participants to take an annuity in order to qualify for the credit is not desirable. In general, alternative PBGC payees include alternative payees under a qualified domestic relations order and beneficiaries of deceased employees who are receiving payments from the PBGC. Many believe that fairness requires that such individuals should be treated as eligible PBGC pension recipients.

Certain commonwealths and possessions

The proposal providing that the Commonwealths of Puerto Rico and the Northern Mariana Islands, American Samoa, Guam, and the U.S. Virgin islands are deemed to be States for purposes of the State-based coverage rules allows such possessions and commonwealths to elect a State-based coverage option, which will allow residents greater access to the credit. Under present law, if an individual meets the definition of an eligible individual, residents of the possessions and commonwealths may be eligible for the credit; however, because the possession or commonwealth in which they live is not able to offer qualified health insurance, such individuals are generally unable to access the credit. The proposal would allow certain possessions and commonwealths to offer qualified health insurance. Proponents argue that since the credit is targeted to specific groups of individuals (i.e., individuals receiving benefits under TAA or from the PBGC), residents of such commonwealths and possessions who are eligible individuals should not be denied the credit because their residence cannot offer a qualified State-based option.

While residents of the possessions and commonwealths are U.S. citizens,[100] special tax rules apply. Some question whether it is appropriate to provide a refundable health tax credit to residents of possessions and commonwealths who may never pay U.S. tax. Certain other tax credits are not available to such individuals. For example, the earned income credit and child tax credit are generally not available to such residents.[101]

Expanded disclosure

Proponents argue that modifying the disclosure provisions is necessary to make the advance payment program administrable. The proposal would eliminate uncertainty regarding disclosures permitted for purposes of the credit. Under present law, disclosure is permitted only to providers of health insurance. Proponents argue that in order to facilitate operation of the advance payment program it is necessary that disclosure of certain information be permitted to employers and administrators of health plans and to contractors of providers of health insurance.

Since advance payment of the credit became available August 1, 2003, a consent mechanism has been used to the extent that disclosures not technically permitted under the statute are necessary. Proponents argue that clarifying the disclosure provisions statutorily would simplify administration of the credit.

Many believe that taxpayer information should be highly safeguarded and that any expansion of the disclosure rules should be as narrow as possible. For example, some argue that, given the breadth of the present-law statute, the use of contractors could expand significantly the risk of unauthorized disclosure of sensitive information. Some argue that if present law were narrowed to the discrete items relating to the health program, such risk would be diminished. Others argue that items such as taxpayer identification numbers and health insurance membership are commonly obtained by the health plans and are not as sensitive as other return information.

State continuation coverage

The proposal providing that State continuation coverage automatically qualifies as qualified health insurance results in removing certain State-based coverage requirements from State continuation coverage. These requirements include guaranteed issue, no imposition of preexisting conditions, nondiscriminatory premiums and similar benefits. Proponents argue that many States lack qualified State-based coverage and allowing State continuation coverage to automatically qualify would allow more individuals to use the credit. Proponents also argue that since State continuation coverage is similar to COBRA continuation, which is not subject to the State-based coverage requirements, it is appropriate to waive such requirements for State continuation coverage. Proponents argue that it is inappropriate for the State-based coverage

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[100] There is an exception for those on American Samoa who are U.S. nationals.

[101] The refundable child tax credit is available to residents of the possessions if the individual has three of more qualifying children and pays FICA or SECA taxes. However, the President's fiscal year 2005 budget proposal includes a proposal to repeal this rule and to require the taxpayer to reside in the United States to be eligible for the credit.

requirements to apply to State continuation coverage as certain rules applicable to State continuation coverage are inconsistent with such requirements.

Critics argue that it is extremely important for individuals to have the protections relating to guaranteed issue, preexisting conditions, nondiscriminatory premiums and similar benefits. They argue that if the applicable requirements are waived, individuals will loose valuable rights with respect to their health care. In addition, opponents argue that if State continuation coverage automatically meets the requirements for qualified health insurance, States will be less inclined to work towards producing a qualifying option that includes the otherwise applicable requirements. Critics of the proposal argue that if all State-based coverage must satisfy the requirements, States will eventually produce a qualifying option which will allow its citizens access to the credit while retaining the important consumer protections. This change is viewed by critics as a substantive change from what was originally intended, rather than a clarification of present law.

Other specified coverage of alternative TAA recipients

Removing the special rule for other specified coverage that applies only to alternative TAA recipients results in applying the same definition of other specified coverage to all eligible individuals. Under the proposal, for all eligible individuals, specified coverage would include coverage under a health plan maintained by an employer (except for insurance substantially all of which is for excepted benefits) than pays at least 50 percent of the cost of coverage and certain governmental health programs. Proponents argue that the proposal would reduce complexity in administering the credit, as similar rules would apply to all individuals. Some argue that despite the complexity in having different rules, the special rule for alternative TAA recipients should be retained.

Prior Action

No prior action.

C. Provisions Relating to Charitable Giving

1. Provide a 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.[102]

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.[103] 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.[104]

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;

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

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

[104] Sec. 6115.

(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 2004 is $142,700 ($71,350 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 provides a deduction from adjusted gross income for charitable contributions of cash made by taxpayers who do not itemize deductions. This deduction is allowed in addition to the standard deduction and generally is subject to the tax rules normally governing charitable deductions, such as the substantiation requirements and percentage limitations. The deduction is allowed in computing alternative minimum taxable income and would not affect the calculation of adjusted gross income.

Taxpayers are allowed to deduct aggregate cash contributions that exceed a floor of $250 ($500 for married taxpayers filing a joint return). The deduction is limited to no more than $250 ($500 for married taxpayers filing a joint return). The deduction floors and limits are indexed for inflation after 2004.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003.

Analysis

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 to donate cash to charities. 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.[105] 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.[106] 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 requires that aggregate cash contributions exceed a specified floor amount and caps the nonitemizer deduction at an

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[105] 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 28-percent tax bracket, a $100 cash gift to charity reduces the taxpayer's taxable income by $100, and thereby reduces tax liability by $28. As a consequence, the $100 cash gift to charity reduces the taxpayer's after-tax income by only $72. Economists would say that the price of giving $100 cash to charity is $72 for this taxpayer.

[106] 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.

applicable amount. The tax price of giving is only reduced for contribution amounts above the required floor and below the cap. Nonitemizers who make contributions to charity less than the applicable floor amount do not face a reduced tax price for additional giving, until their contributions exceed the floor amount. Nonitemizers who give amounts in excess of the cap 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 limited cases, taxpayers could find it beneficial to reduce charitable donations.[107]

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.[108] In addition, most studies rely upon data relating to taxpayers who itemize

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[107] Take, for example, a taxpayer, not filing a joint return, 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 $250 ($500 for joint filers) in charitable contributions and total other qualifying itemized deductions that are less than the standard deduction plus $250 ($500 for joint filers)). In such a case, the proposal reduces the incentive to make additional charitable contributions and also could encourage a taxpayer to reduce contributions to no more than $500 ($1,000 for joint filers) (assuming the tax incentive was a determinative factor for gifts over $250 ($500 for joint filers)). 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. Because of the proposal's design with the floor and cap separated by $250 ($500 in the case of a joint return), the number of taxpayers who find themselves in such circumstances is likely to be limited.

[108] *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*, vol. 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*, vol. 103, August 1995, at 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, at 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.

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.[109]

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.[110]

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

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

[110] 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*.

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,[111] and that are available as entitlements to those organizations that meet the statutory 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 3 below offers some indirect evidence on the magnitude of such giving. The second column of Table 3 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, the third column of Table 3 reports itemized deductions claimed for charitable donations as reported to the Internal Revenue Service. Comparison of the two columns would suggest that in 2000, nearly $35 billion in charitable contributions made by individuals were not claimed as itemized deductions. Unfortunately, differences in the amounts reported in columns two and three of Table 3 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.[112] These findings suggest that if one were to use the difference in the amounts reported in columns two and three to estimate the magnitude of charitable donations by non-itemizers that the result would be to under-estimate actual donations by non-itemizers.[113] 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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[111] 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.

[112] 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, at 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.

[113] Such a conclusion assumes that the figures reported in the second column of Table 3 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 3.–Individual Charitable Donations, 1984-2001
(Billions of Dollars)

Year	Total Individual Donations Estimated to Have Been Received by Charitable Organizations[1]	Individual Itemized Charitable Donations Claimed on Tax Returns[2]
1984	56.46	42.12
1985	57.39	47.96
1986	67.09	53.82
1987	64.53	49.62
1988	69.98	50.95
1989	79.45	55.46
1990	81.04	57.24
1991	84.27	60.58
1992	87.70	63.84
1993	92.00	68.35
1994	92.52	70.54
1995	95.36	74.99
1996	107.56	86.16
1997	124.20	95.82
1998	138.35	109.24
1999	155.24	125.80
2000	175.10	140.68
2001	182.47	139.24
2002	183.73	136.84[3]

[1] Giving USA 2003. Data do not include donations from trusts. Tabulations prepared by the staff of the Joint Committee on Taxation.
[2] Individual itemized deductions taken from Internal Revenue Statistics of Income data. Tabulations prepared by the staff of the Joint Committee on Taxation.
[3] Preliminary, advance estimate from Internal Revenue Service Statistics of Income data..

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."[114]

The structure of the proposal also adds complexity. The floor and ceiling may be confusing to taxpayers. The proposal would require two additional lines on the individual income tax return forms and modification to the form instructions. The deduction is available only for contributions that exceed a certain level, so taxpayers must maintain records even though the deduction might not be available at year's end. 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

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 $250[115] 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 need to keep records of potential itemized deductions in order to make the calculation, and thus simplification benefits are diminished.

Prior Action

The President's fiscal year 2004 and 2003 budget proposals contained a similar provision. The President's fiscal year 2001 and 2002 budget proposals also contained proposals that would have provided a charitable nonitemizer deduction for a percentage of a taxpayer's charitable contributions up to certain limits.

The "CARE Act of 2003," S. 476, as passed by the Senate on April 9, 2003, contains a similar proposal. H.R. 7, "The Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003 includes a similar proposal. Both proposals would expire after two years, whereas the President's proposal would make the deduction permanent.

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 for 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,

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

[115] This dollar amount is $500 in the case of a joint return. Under the proposal both the $250 and $500 amounts would be indexed in years after 2005.

$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.[116]

2. Permit 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.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to 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.[117]

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.[118] In addition, present law requires that any charity that

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[116] 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.

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

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

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.[119]

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.

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 2004 is $142,700 ($71,350 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.[120] 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

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[119] Sec. 6115.

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

the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[121] 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 59-½ 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 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;[122] (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, under which distributions from the IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-½

Traditional and Roth IRAs are subject to post-death minimum distribution rules that require that distributions upon the death of the IRA owner must begin by a certain time.

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

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

Description of Proposal

The proposal provides 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 does 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 is available for distributions made on or after the date the IRA owner attains age 65 and applies 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 are 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, are subject to the present law charitable contribution deduction rules.

Effective date.–The proposal is effective for distributions after December 31, 2003.

Analysis

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 overall limit on itemized deductions. The proposal will avoid these limitations and therefore might encourage additional charitable giving by increasing the tax benefit of the donation for 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 will be made in any event and will not encourage additional giving.

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 will 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 can 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.

In addition, some argue that the proposal inappropriately will 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 will spur additional gifts by circumventing the percentage limitations, IRA owners may spend more of their retirement

money for nonretirement purposes than under present law. Some also argue that, in the early years of retirement, an individual might not accurately assess his or her long-term retirement income needs. For example, the individual might not make adequate provision for health care or long-term care costs later in life. Some therefore argue that IRA distributions to charity should be permitted, if at all, only after age 70.

Complexity issues

The proposal adds complexity to the tax law by creating an additional set of rules applicable to charitable donations. Taxpayers who own IRAs and make such donations will 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 will 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 is 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

A similar proposal was included in the President's fiscal year 2004 budget proposal. The President's fiscal year 2002 and 2003 budget proposals included a similar proposal, except that the exclusion would have applied to distributions made on or after the date the IRA owner attained age 59-½.

In the 107th Congress, H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, included a similar provision, except the H.R. 7 provision would have applied only to distributions on or after the date the IRA owner attained age 70-½. H.R. 7 also provided for a similar exclusion for transfers to split-interest entities, including charitable remainder trusts, pooled income funds, and charitable gift annuities. Under H.R. 7 as reported by the Senate Finance Committee on July 16, 2002, the exclusion for transfers to split interest entities would have applied to distributions made on or after the date the IRA owner attained age 59-½.

In the current Congress, S. 476, the "CARE Act of 2003," as passed by the Senate on April 9, 2003, includes a similar provision that provides an exclusion for an otherwise taxable distribution from an IRA that is made (1) directly to a charitable organization on or after the date the IRA owner attains age 70-½, or (2) to a split-interest entity on or after the date the IRA

owner attains age 59-½. H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, includes a similar provision, except the H.R. 7 provision applies to distributions made directly to a charitable organization or to a split-interest entity only on or after the date the IRA owner reaches age 70-½ and the exclusion does not apply to distributions from SIMPLE IRAs or simplified employee pensions ("SEPs").

3. Expand and increase the 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.[123]

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 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.[124]

Description of Proposal

Under the proposal, the enhanced deduction for donations of food inventory is 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, is eligible to claim an enhanced deduction for donations of food inventory. The deduction for donations by S corporations and noncorporate taxpayers is limited to 10 percent of the net income from the associated trade or business. The proposal provides a special rule that would permit certain taxpayers with a zero or low basis in the food donation (e.g., taxpayers that

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

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

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 will equal 50 percent of the food's fair market value. The enhanced deduction for food inventory will 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 provides 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 (taking into account both type and quality) 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 is effective for taxable years beginning after December 31, 2003.

Analysis

Policy issues

In the absence of the enhanced deduction of present law, if the taxpayer were to dispose of excess inventory by dumping the excess food in a garbage dumpster, the taxpayer generally could claim the purchase price of the inventory (the taxpayer's basis in the property) as an expense against his or her gross income. In the absence of the enhanced deduction of present law, if the taxpayer were to donate the excess food inventory to a charitable organization that maintains a food bank, the taxpayer generally would be able to claim a charitable deduction equal to the taxpayer's basis in the food inventory (subject to certain limits on charitable contributions). Viewed from the taxpayer's profit motive, the taxpayer would be indifferent between donating the food or dumping the food in a garbage dumpster. If the taxpayer must incur cost to deliver the food to the charity that maintains the food bank, the taxpayer would not find it in his or her financial interest to donate the excess food inventory to the food bank. The enhanced deduction creates an incentive for the taxpayer to contribute excess food inventory to charitable organizations that provide hunger relief.

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 encourage more businesses to donate more food to charitable organizations that provide hunger relief. 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.[125]

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. For example, assume a taxpayer whose income is taxed at the highest corporate income tax rate of 35 percent has purchased an avocado for $0.75. The taxpayer previously could have sold the avocado for $1.35, but now could only sell the avocado for $0.30. If the taxpayer sold the avocado for $0.30, the taxpayer would incur a loss of $0.45 ($0.75 basis minus $0.30 sales revenue) on the sale. Because the loss on the sale of the avocado reduces the taxpayer's taxable income, the taxpayer's tax liability would decline by approximately $0.16 ($0.45 multiplied by 35 percent), so the net loss from the sale in terms of after-tax income would be $0.29. If, alternatively, the taxpayer had donated the avocado to the local food bank, and under the proposal were allowed to claim a deduction for the previous fair market value of $1.35, the taxpayer's taxable income would be reduced by $1.35 resulting in a reduction in tax liability of approximately $0.47 ($1.35 multiplied by 35 percent). However, the taxpayer originally purchased the avocado for $0.75 and, as the avocado is donated, this expense cannot be deducted as a cost of goods sold. By donating the avocado, the taxpayer's net loss on the avocado is $0.28 (the $0.47 in income tax reduction minus the cost of acquiring the avocado, $0.75). Under the proposal, the taxpayer loses less on the avocado by donating the avocado to charity than by selling the avocado.

This possible outcome is a result of permitting a deduction for a value that the taxpayer may not be able to achieve in the market. Whether sold or donated, the taxpayer incurred a cost to acquire the good. When a good is donated, it creates "revenue" for the taxpayer by reducing his or her taxes otherwise due. When the value deducted exceeds the revenue potential of an actual sale, the tax saving from the charitable deduction can exceed the sales revenue from a sale. While such an outcome is possible, in practice it may not be the norm. In part because the proposal limits the enhanced deduction to the lesser of the measure of fair market value or twice the taxpayer's basis, it can only be more profitable to donate food than to sell food if the taxpayer would otherwise be selling the food to be donated at a loss. In general, it depends upon the amount by which the deduction claimed exceeds the taxpayer's basis in the food relative to the extent of the loss the taxpayer would incur from a sale.[126]

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[125] *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).

[126] In general, it is never more profitable to donate food, than to sell food unless the taxpayer is permitted to deduct a value other than the current fair market value of the food. To see this:

- let Y denote the taxpayer's pre-tax income from all other business activity;
- let B denote the taxpayer's acquisition cost (basis) of the item to be donated;

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.[127] 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.

- let a represent the percentage by which the permitted deduction exceeds the taxpayer's basis, that is aB equals the value of the deduction permitted;

- let ß equal the current market value as a percentage of the taxpayer's basis in the item, that is the revenue that could be attained from sale is ßB;

and let t denote the taxpayer's marginal tax rate.

Further assume that $ß < 1 < a$, that is, at the current market value the taxpayer would be selling at a loss, but previously the taxpayer could sell at a profit.

The taxpayer's after-tax income from sale of the item is $(Y + ßB – B)(1-t)$.

Under the proposal, the taxpayer's after-tax income from contribution of the item is $Y – B – t(Y – aB)$. For the case in which the permitted deduction would exceed twice the taxpayer's basis, the taxpayer's after-tax income from contribution of the item is $Y – B – t(Y – 2B)$.

It is more profitable to donate the item than to sell it when the following inequality is satisfied.

(1) $(Y + ßB – B)(1-t) < Y – B – t(Y – aB)$.

This inequality reduces to:

(2) $ß/(ß + (a-1)) < t$.

Whether it is more profitable to donate food than to sell food depends upon the extent to which the food would be sold at a loss (ß) relative to the extent of the loss plus the extent to which the permitted deduction exceeds the taxpayer's basis (a-1), compared to the taxpayer's marginal tax rate. Because under present law, the marginal tax rate is 0.35, equation (2) identifies conditions on the extent of loss and the permitted deduction that could create a situation where a charitable contribution produces a smaller loss than would a market sale, such as the example in the text. In the case where the taxpayer's deduction would be limited to twice basis, it is possible to show that for a marginal tax rate of 35 percent, the current market value of the item to be donated must be less than 53.8 percent of the taxpayer's basis in the item, that is, $ß < 0.538$.

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

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, however, 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. 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.

Taxpayers who contribute food inventory must consider multiple factors to ensure that they deduct the permitted amount (and no more than the permitted amount) with respect to contributed food. Taxpayers who are required to maintain inventories for their food purchases must compare the fair market value of the contributed food with the basis of the food (and twice the basis of the food), and coordinate the resulting contribution deduction with the determination of cost of goods sold.[128] Taxpayers who are not required to maintain inventories for their food purchases generally will have a zero or low basis in the contributed food, but are permitted to use a deemed basis rule that provides such taxpayers a contribution deduction equal to 50 percent of the food's fair market value. Taxpayers who are not required to maintain inventories need not coordinate cost of goods sold deductions or inventory adjustments with contribution deductions, and are not required to recapture the previously expensed costs associated with the contributed food.

Prior Action

The President's fiscal year 2003 and 2004 budget proposals contained a similar proposal.

The "CARE Act of 2003," S. 476, passed by the Senate on April 9, 2003, contains a similar proposal.

The "Charitable Giving Act of 2003," H.R. 7, passed by the House of Representatives on September 17, 2003, contains a proposal that is similar with respect to defining the fair market value of contributed food and with respect to extending the enhanced deduction to taxpayers other than C corporations.

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[128] Such taxpayers must remove the amount of the contribution deduction for the contributed food inventory from opening inventory, and do not treat the removal as a part of cost of goods sold. IRS Publication 526, *Charitable Contributions*, 7-8.

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

Present Law

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)[129] 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.[130] 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.[131]

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 was 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.[132]

Nonoperating private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under section 4942. The minimum amount of qualifying

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[129] Sec. 4942(g).

[130] Sec. 4940(e).

[131] Sec. 4942.

[132] 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).

distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[133]

Description of Proposal

The proposal replaces the two rates of tax with a single rate of tax and sets such rate of tax at one percent. A tax-exempt private foundation is subject to tax on one percent of its net investment income. A taxable private foundation is 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 repeals the special one-percent excise tax for private foundations that exceed their historical level of qualifying distributions.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003.

Analysis

The proposal has the effect of increasing the required minimum charitable payout for private foundations that pay the excise tax at the two-percent rate.[134] This may result in increased charitable distributions for private foundations that pay only the minimum in charitable distributions under present law. 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 decreases the amount of excise tax paid on net investment income for such foundations, the proposal increases such foundations' required minimum amount of charitable distributions by an amount equal to one percent of the foundation's net investment income. Thus, the proposal results 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). However, a reduction in the excise tax rate from 2 percent to 1 percent may result in increased charitable distributions to the extent that a foundation decides to pay out the amount that otherwise would be paid in tax for charitable purposes.

The proposal also eliminates the present-law two-tier tax structure. Some have suggested that the two-tier excise tax is an incentive for foundations to increase the amounts they distribute

[133] Sec. 4942(d)(2).

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

to charities.[135] 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.[136] 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 manage its distributions actively so that the foundation qualifies for the one-percent tax rate without substantially increasing its payout rate.[137] 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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[135] 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.

[136] *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.

[137] For example, if over a 10-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 10-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.[138]

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.[139] 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 1999, 42 percent of foundations were one-percent tax rate payors and 58 percent were two-percent rate payors. Among large foundations (assets of $50 million or greater) 58 percent were one-percent rate payors and 42 percent were two-percent rate payors.[140] 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.[141]

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

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[138] 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.

[139] 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.

[140] *See* Figure E in Melissa Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999," Internal Revenue Service, *Statistics of Income Bulletin*, 22, Fall 2002 at 143.

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

or 5.0 percent in each year from 1991 through 1995 and was 5.0 percent in 1999.[142] The median payout rates for foundations with assets between $10 million and $50 million declined annually from 5.4 percent in 1990 to 5.1 percent in 1995 and 1999. 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 and 5.4 percent in 1999.[143] 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.

The proposal reduces complexity for private foundations by replacing the two-tier tax on net investment income with a one-tier tax. Under the proposal, private foundations do 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 2003 and 2004 budget proposals included a similar proposal.

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, included a similar proposal.

H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a similar proposal.

5. 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.[144]

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[142] *See* Figure I in Paul Arnsberger, "Private Foundations and Charitable Trusts, 1995," Internal Revenue Service, *Statistics of Income Bulletin*, 18, Winter 1998-1999 at 73; Figure I in Ludlum, "Domestic Private Foundations and Charitable Trusts, 1999" at 148.

[143] *Id.*

[144] Sec. 664(d).

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; (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.[145]

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.[146]

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 imposes a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust. This replaces the present-law rule that removes 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 is treated as paid from corpus. The unrelated business taxable income is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003, regardless of when the trust was created.

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[145] Sec. 664(b).

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

Analysis

The proposal 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 avoids this result by requiring a trust to pay the amount of the unrelated business taxable income as an excise tax but does not require the trust to pay tax on all of its other income for the year. In addition, the proposal is 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 also may enable trusts to choose to make certain investments that have small amounts of unrelated business income 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 may be unattractive for charitable remainder trusts under present law because the unrelated income causes 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 also 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. Although present law requires that a charitable remainder trust become a taxable trust for a year in which the trust has unrelated business taxable income, a charitable remainder trust nevertheless may invest in assets that produce significant unrelated business income but pay tax only on the trust's undistributed income. This is because, as a taxable trust, the 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.) Thus, proponents argue that the proposal better deters trusts from making investments that generate significant unrelated business taxable income because the 100 percent excise tax would be prohibitive. On the other hand, some question whether such a deterrent is the right policy in cases where a trustee determines that investment in assets that produce unrelated business taxable income will increase the (after tax) rate of return to the trust (and thus inure to the benefit of the charitable remainderman).

The proposal provides that unrelated business income is treated as ordinary income to the trust and taxes are paid from corpus. Thus, the proposal treats the trust beneficiary the same as under present law, that is, distributions of the unrelated business income are taxed as ordinary income to the beneficiary. As a result, 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.) Proponents of the proposal would argue that double taxation is not a concern because the excise

tax is intended as a penalty for incurring unrelated business income. Proponents also would argue that although an alternative approach, for example, to tax the unrelated business income as an excise tax but not again when distributed, would avoid any perceived double taxation of the unrelated income, such an alternative would have undesired effects. Proponents would argue that if unrelated income is not taxed when distributed, a trust might have a strong incentive to invest in assets that produce unrelated income in order to convey a benefit to the beneficiary that is not available under present law (capital gain income or tax-free return of corpus instead of ordinary income). In addition, proponents would note, the charitable remainderman's interest would be diminished to the extent a trust invested significantly in unrelated business income producing assets.

The proposal simplifies the operation of charitable remainder trusts in that a trust with a small amount of unrelated business taxable income does not lose its tax exemption and therefore does not need to file income tax returns and compute its taxable income as if it were a taxable trust. This has the effect of not discouraging trustees to make investments that might entail having a small amount of unrelated business taxable income.

Prior Action

A similar proposal was included in the President's fiscal year 2003 and 2004 budget proposals.

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, included 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. H.R. 7, as reported by the Senate Committee on Finance on July 18, 2002, included the proposal.

H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a proposal similar to the proposal in the Community Solutions Act of 2001.

S. 476, The "CARE Act of 2003," as agreed to by the Senate on April 9, 2003, contained a similar proposal.

6. Modify the 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.[147] A shareholder of an S corporation reduces the basis

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

in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[148] 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 allows 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.[149]

Effective date.–The proposal applies to taxable years beginning after December 31, 2003.

Analysis

The proposal preserves 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 is similar to the treatment of contributions made by a partnership.

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

Prior Action

The President's fiscal year 2003 and 2004 budget proposals contained a substantially similar proposal.

H.R. 7, the "Charitable Giving Act of 2003," as passed by the House of Representatives on September 17, 2003, included a similar proposal.

S. 476, The "CARE Act of 2003," as agreed to by the Senate on April 4, 2003, contained a similar proposal.

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

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

7. Repeal $150 million limit for qualified 501(c)(3) bonds

Present Law

Interest on State or local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is provided in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in section 501(c)(3) ("section 501(c)(3) organizations") if the activities do not constitute an unrelated trade or business.

Section 501(c)(3) organizations are treated as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(c)(3) bonds," subject to the restrictions of section 145. Prior to the Taxpayer Relief Act of 1997 (the"1997 Act"), the most significant of these restrictions limited the amount of outstanding bonds from which a section 501(c)(3) organization could benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control were treated as a single organization. The limit did not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

The "1997 Act" repealed the $150 million limit for bonds issued after the date of enactment (August 5, 1997), to finance capital expenditures incurred after such date.

Description of Proposal

The proposal repeals the $150 million limit for qualified 501(c)(3) bonds in its entirety.

Effective date.–The proposal is effective for bonds issued after the date of enactment.

Analysis

Because the 1997 Act provision applies only to bonds issued with respect to capital expenditures incurred after August 5, 1997, the $150 million limit continues to govern the issuance of other non-hospital qualified 501(c)(3) bonds (e.g., advance refunding bonds with respect to capital expenditures incurred such on or before such date, or new-money bonds for capital expenditures incurred on or such date). Thus, there are two rules governing qualified 501(c)(3) bonds for capital expenditures. The application of a particular rule depends on whether the capital expenditures were incurred on or before or after the date the 1997 Act was enacted.

As noted above, the $150 million volume limit continues to apply to qualified 501(c)(3) bonds for capital expenditures incurred on or before August 5, 1997. (Typically, these will be advance refunding bonds). The limit does not apply to bonds to finance capital expenditures incurred after that date. The Senate Finance Committee report states that the purpose of the repeal of the $150 million limit was to correct the disadvantage the limit placed on 501(c)(3) organizations relative to substantially identical governmental institutions:

> The Committee believes a distinguishing feature of American society is the singular degree to which the United States maintains a private, non-profit sector of private higher education and other charitable institutions in the public service. The Committee believes it is important to assist these private institutions in their advancement of the public good. The Committee finds particularly inappropriate the restrictions of present law which place these section 501(c)(3) organizations at a financial disadvantage relative to substantially identical governmental institutions. For example, a public university generally has unlimited access to tax-exempt bond financing, while a private, non-profit university is subject to a $150 million limitation on outstanding bonds from with it may benefit. The Committee is concerned that this and other restrictions inhibit the ability of America's private, non-profit institutions to modernize their educational facilities. The Committee believes the tax-exempt bond rules should treat more equally State and local governments and those private organizations which are engaged in similar actions advancing the public good.[150]

Although the conference report on the 1997 Act noted the continued applicability of the $150 million limitation to refunding and new-money bonds, no reason was given for retaining the rule.[151] Thus, it appears that eliminating the discrepancy between pre-August 5, 1997, and post-August 5, 1997, capital expenditures would not violate the policy underlying the repeal of the $150 million limitation.

Prior Action

A similar proposal was included in the President's fiscal year 2004 budget proposal.

8. Repeal restrictions on the use of qualified 501(c)(3) bonds for residential rental property

Present Law

In general

Interest on State or local government bonds is tax-exempt when the proceeds of the bonds are used to finance activities carried out by or paid for by those governmental units. Interest on bonds issued by State or local governments acting as conduit borrowers for private businesses is taxable unless a specific exception is included in the Code. One such exception allows tax-exempt bonds to be issued to finance activities of non-profit organizations described in Code section 501(c)(3) ("qualified 501(c)(3) bonds").

For a bond to be a qualified 501(c)(3) bond, the bond must meet certain general requirements. The property that is to be provided by the net proceeds of the issue must be owned by a 501(c)(3) organization, or by a government unit. In addition, a bond failing both a modified private business use test and a modified private security or payment test would not be a qualified

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[150] S. Rep. 105-33 (June 20, 1997), at 24-25.

[151] H. Rep. 105-220 (July 30, 1997), at 372-373.

501(c)(3) bond. Under the modified private business use test at least 95 percent of the net proceeds of the bond must be used by a 501(c)(3) organization in furtherance of its exempt purpose. Under a modified private security or payment test, the debt service on not more than 5 percent of the net proceeds of the bond issue can be (1) secured by an interest in property, or payments in respect of property, used by a 501(c)(3) organization in furtherance of an unrelated trade or business or by a private user, or (2) derived from payments in respect of property, or borrowed money, used by a 501(c)(3) organization in furtherance of an unrelated trade or business or by a private user.

Qualified 501(c)(3) bonds are not subject to (1) the State volume limitations, (2) the land and existing property limitations, (3) the treatment of interest as a preference item for purposes of the alternative minimum tax and (4) the prohibition on advance refundings.

Qualified residential rental projects

In general

The Code provides that a bond which is part of an issue shall not be a qualified 501(c)(3) bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units (sec. 145(d)(1)). Exceptions to this rule are provided for facilities that meet the low-income tenant qualification rules for qualified residential rental projects financed with exempt facility private activity bonds,[152] or are new or substantially rehabilitated (sec. 142(d) and 145(d)(2)).

Acquisition of existing property

Qualified 501(c)(3) bonds issued to acquire existing residential rental property that is not substantially rehabilitated must meet certain low-income tenant qualification rules. Section 142(d) sets forth those rules. Section 142(d) requires for the qualified project period (generally 15 years) that (1) at least 20 percent of the housing units must be occupied by tenants having incomes of 50 percent or less of area median income or (2) 40 percent of the housing units in the project must be occupied by tenants having incomes of 60 percent or less of the area median income.

New construction or substantial rehabilitation

In the case of a "qualified residential rental project" that consists of new construction or substantial rehabilitation, qualified 501(c)(3) bonds are not required to meet the low-income tenant qualification rules that otherwise would be applicable.

[152] Section 142(a)(7) describes an exempt facility bond as any bond issued as part of an issue of bonds if 95 percent or more of the net proceeds of the issue are to be used to provide qualified residential rental projects.

Description of Proposal

The proposal repeals the low-income tenant qualification and substantial rehabilitation rules for the acquisition of existing property with qualified 501(c)(3) bonds.

Effective date.–The proposal is effective for bonds issued after the date of enactment.

Analysis

The current low-income tenant rules to qualified 501(c)(3) bonds resulted from Congressional concern that qualified 501(c)(3) bonds were being used in lieu of exempt facility bonds to avoid the low-income tenant rules applicable to exempt facility bonds. The Ways and Means Committee report noted:

> The Committee has become aware that, since enactment of the Tax Reform Act of 1986, many persons have sought to avoid the rules requiring that, to qualify for tax-exempt financing, residential rental property serve low-income tenants to a degree not previously required. The most common proposals for accomplishing this result have been to use qualified 501(c)(3) or governmental bonds to finance rental housing. Frequently, the proposals have involved the mere churning of "burned-out" tax shelters with the current developers remaining as project operators under management contracts producing similar returns to those they received in the past. The committee finds it anomalous that section 501(c)(3) organizations--charities--would attempt in these or any other circumstances to finance with tax-exempt bonds rental housing projects that serve a more affluent population group than those permitted to be served by projects that qualify for tax-exempt exempt-facility bond financing.[153]

In conference, the applicability of the low-income tenant rules was limited to the acquisition of existing property.[154] It has been argued that the disparity in the treatment of existing facilities versus new facilities causes complexity. Some degree of simplification might be achieved through the elimination of the low-income tenant rules. Nonetheless, some might argue that the concerns that prompted the application of the low-income tenant rules to existing property would once again arise upon removal of these limitations.

There have been reports that there is a shortage of affordable rental housing. By removing the restrictions on existing property, some might argue that charities would not be inclined to serve low-income tenants to the same degree. Proponents of the restrictions might argue that charities, in particular, should provide affordable housing to low-income persons as part of their charitable mission to serve the poor and distressed.

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[153] H.R. Rep. No. 100-795 at 585 (1988). The report also noted: "The press has reported housing industry representatives stating publicly that a primary attraction of some housing financed with governmental and qualified 501(c)(3) bonds is that the low-income tenant requirements and State volume caps applicable to for-profit developers do not apply." *Id.*

[154] H.R. Conf. Rep. 100-1104, vol. II at 126 (1988).

Others might argue that an affordable housing shortage is not widespread and that such issues would be better addressed through efforts to directly assist low-income persons rather than by imposing restrictions on the property acquired by the charity. Further, because qualified 501(c)(3) bonds are to be used to further the exempt purposes of the charity, there is a limit on the extent the charity can operate like a commercial enterprise.

As noted above, the interest on qualified 501(c)(3) bonds is exempt from tax, and is not a preference for purpose of the alternative minimum tax. Unlike some other private activity bonds, qualified 501(c)(3) bonds are not subject to the State volume limitations and therefore, do not have to compete with other private activity bond projects for an allocation from the State. Proponents of the restrictions might argue that the restrictions are not unreasonable given the preferential status of qualified 501(c)(3) bonds and the fact that such charities could be viewed as helping alleviate a burden on government to benefit those most in need.

Prior Action

A similar proposal was included in the President's fiscal year 2004 budget proposal.

D. Extend, Increase and Expand the Above-the-Line Deduction for Qualified Out-of-Pocket Classroom Expenses

Present Law

Deduction for out-of-pocket classroom expenses incurred by teachers and other educators

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $142,700 (for 2004). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed an above-the-line deduction. Specifically, for taxable years beginning in 2002 and 2003, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school, which provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2003.

General rules regarding education expenses

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.[155] Education expenses are not deductible if

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

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.

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during a taxable year that are required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible educational institution of higher education for courses of instruction of such individual at such institution.[156]

Unreimbursed educational expenses incurred by employees

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 employee 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 2004 is $142,700 ($71,350 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, although this elimination of the limitation sunsets on December 31, 2010.[157]

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.

Description of Proposal

The temporary provision allowing eligible educators an above-the-line deduction for certain expenses is made permanent, and the maximum deduction is increased to $400. As under current law, the provision applies to teachers and other school personnel employed by public entities, charter schools or private schools (as determined under State law). The current-law 900-hour rule is clarified to refer to a school year ending during the taxable year. Eligible, unreimbursed expenses are expanded to include teacher training expenses related to current

[156] Sec. 222.

[157] A separate proposal contained in the President's fiscal year 2005 budget permanently extends the elimination of the overall limitation on itemized deductions after 2010.

teaching positions. Neither travel nor lodging expenses nor expenditures related to religious instruction or activities are eligible. Expenses claimed as an above-the-line deduction may not be claimed as an itemized deduction or taken into account in determining any other tax benefit such as Hope or lifetime learning credits. Taxpayers are required to retain receipts for eligible expenditures along with a certification from a principal or other school official that the expenditures qualified.

Effective date.–The proposal is effective for expenses incurred in taxable years beginning after December 31, 2003.

Analysis

Policy issues

The proposal and the present-law section 62 above-the-line deduction attempt to make fully deductible many of the legitimate business expenses of eligible schoolteachers. As described below, and absent an above-the-line deduction, the expenses might otherwise be deductible except for the two-percent floor that applies to miscellaneous itemized deductions. Some have observed that the two-percent floor increases pressure to enact above-the-line deductions on an expense-by-expense basis. 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.[158]

The proposal expands the present-law above-the-line deduction for eligible educators by increasing the maximum deduction from $250 to $400, thereby making additional legitimate business expenses deductible. As is the case with the present-law above-the-line deduction, the proposal presents 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.

Complexity issues

Three provisions of present law restrict the ability of teachers to deduct as itemized deductions those 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

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[158] *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).

sources of complexity and has recommended that such provisions be repealed.[159] These provisions do not apply to eligible expenses under the proposal. While repealing these provisions for all taxpayers reduces the complexity of the Federal tax laws, effectively repealing these provisions only for certain taxpayers (such as teachers and other eligible educators) likely increases complexity.

Some may view the present-law above-the-line deduction and the proposal as increasing simplification by providing for deductibility of certain expenses without regard to the present-law restrictions applicable to itemized deductions and the alternative minimum tax. However, several elements of the proposal and the present-law above-the-line deduction increase complexity. The proposal and present-law above-the-line deduction may increase recordkeeping requirements for certain taxpayers. Taxpayers wishing to take advantage of the above-the-line deduction are required to keep records, even if they were not otherwise required to do so because their expenses were not deductible as a result of the 2-percent floor for itemized deductions. In general, enactment of additional above-the-line deductions for specific expenses undermines the concept of the standard deduction, which exists in part to simplify the tax code by eliminating the need for many taxpayers to keep track of specific expenses.

The proposal and the present-law above-the-line deduction do not completely eliminate the need to apply the present-law rules regarding itemized deductions. For example, a teacher with expenses in excess of the $400 cap under the proposal or with other miscellaneous itemized deductions may need to compute tax liability under the present-law itemized deduction rules as well as under the proposal. 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 remain subject to the present-law rules. Similarly, some expenses may either be deductible under the proposal or used for tax benefits under other provisions. For example, certain teacher education expenses may be deductible under the proposal or used for a Hope or Lifetime Learning credit. Taxpayers with such expenses 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 claim more than one tax benefit with respect to the same expense.

Prior Action

Similar proposals were contained in the President's fiscal year 2003 and 2004 budget proposals. A similar provision was contained in the Tax Relief Extension Act of 2003, as passed by the House of Representatives on November 20, 2003.

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[159] *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.

E. Exclude from Income of 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 provides an exclusion from income for the value of any computers, software or other office equipment provided to an individual by that individual's employer. The exclusion is limited to equipment necessary for the individual to perform work for the employer at home but is not limited to business use of such equipment. Therefore, the exclusion applies 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 is 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 deems the value of such use to be zero for tax purposes.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Complexity issues

One purpose of the proposal may be a simplification purpose, that is, to reduce record keeping for employees to whom an employer provides office equipment. The proposal eliminates the need to keep track of personal versus business use of covered equipment.

However, 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 involves a factual inquiry, the proposal increases the complexity of tax administration by increasing the likelihood of factual disputes and litigation.

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 excludes 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.

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 employees (those based on computer applications) over others. As a result, other strategies that could raise the well being of employees may be forgone.

Prior Action

A similar proposal was included in the President's fiscal year 2002, 2003 and 2004 budget proposals.

F. Provide a 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 creates a single-family housing tax credit. Pursuant to a plan of allocation, State or local housing credit agencies will award first-year credits to new or rehabilitated housing units comprising a project for the development of single-family housing in census tracts with medium incomes of 80 percent or less of the greater of area or statewide median income or areas of chronic economic distress designated within five years prior to allocation.

Eligible taxpayers generally are 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 cannot exceed the present value of 50-percent of the eligible basis of that housing unit. Rules similar to the present-law rules for the LIHC determine eligible basis for this credit. Neither land nor existing structures are included in eligible basis for purposes of this credit. Units in rehabilitated structures qualify for the credit only if rehabilitation expenditures exceeded $25,000. This credit is 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 means an individual with income of 80 percent (70 percent for families with less than three members) or less of area median income. A qualified buyer will not have to be a first-time homebuyer.

Similar to the present-law low-income rental housing tax credit, this credit provides the greater of $1.80 per capita or $2.075 million of tax credit authority annually to each State beginning in calendar year 2005. These amounts are indexed for inflation. Each State (or local government) allocates 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 are treated as single-family housing for purposes of the credit. Credits allocated to a housing unit will 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 will apply regarding

plans on allocations, credit carryforwards, credit returns and a national pool of unused allocations.

The qualified developers or investor partnerships will claim the credit for the five years after the qualified property is sold to a qualified buyer. However, no credit is 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. Rules similar to the present-law LIHC rules apply to determination of eligible basis, present value calculations and reporting requirements.

A qualified homebuyer (not the developer or investor partnership) is 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 is the lesser of: (1) 80 percent of the gain upon resale, or (2) a recapture amount. The recapture amount equals one half the gain resulting from the resale, reduced by $1/36^{th}$ 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 three-year period, then no deductions for depreciation or property taxes can be claimed with respect to such unit for the balance of that three-year period. The proposal does not provide how the qualified homebuyer (or subsequent buyer) will ascertain the recapture amount for their housing unit.

Effective date.–The proposal is effective for first-year credit allocations beginning in calendar year 2005.

Analysis

Complexity issues

The proposal adds 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, will be inherently complex and detailed, and will require significant additional paperwork by taxpayers. The proposal will require the creation of additional tax forms and will 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 will need to be developed. This proposal can 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, will 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, will 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 will 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 will 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 will have earned had the same housing been sold to a non-qualifying homebuyer or comparable or greater to that the developer will 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 can 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[160] the developer/seller may claim under the proposal. Alternatively, there may be no change in purchase price (compared to an otherwise comparable

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[160] The proposal will 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.

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 will 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 accrues to the purchaser.[161] 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. On the other hand, 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 can 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 2000, the percentage of household owner-occupiers among households headed by an individual less than 35 years old was 40.8

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[161] 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.

percent. The percentage of household owner-occupiers among households headed by an individual 35 to 44 years old was 67.9 percent. The percentage of household owner-occupiers among households headed by an individual 65 years old or older was 80.4 percent.[162] By targeting the credit based on annual income, the proposal may provide benefit to two distinct types of families. The proposal provides 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 will provide a benefit to families whose income growth will 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, can 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 can dominate the Jones's offer on an after-tax basis to the seller. The Smith and Jones families can 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 67 percent[163] 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.

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[162] U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States 2001*.

[163] In 2000, of 105.7 million occupied housing units nationwide, 71.3 million were owner-occupied. U.S. Department of Commerce, Economics and Statistics Administration, *Statistical Abstract of the United States 2001*.

Prior Action

A similar proposal was included in the President's fiscal year 2002, 2003 and 2004 budget proposals.

G. 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.*[164] 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 threat of 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 ("CERCLA") cannot qualify as targeted areas. 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.

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

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[164] *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)).

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 a 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 eliminates the requirement that expenditures must be paid or incurred before January 1, 2004, to be deductible as eligible environmental remediation expenditures. Thus, the provision becomes permanent.

Effective date.–The proposal is effective on the date of enactment.

Analysis

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.[165] 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.

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

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[165] 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.

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 IRS audits.

Prior Action

Proposals to make section 198 permanent were included in the President's fiscal year 1999, fiscal year 2000, fiscal year 2001, fiscal year 2002, fiscal year 2003, and fiscal year 2004 budget proposals.

H.R. 3521, the "Tax Relief Extension Act of 2003," as passed by the House of Representatives on November 20, 2003, would extend the present-law deduction for environmental remediation expenditures through December 31, 2004.

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 15 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 to 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 exceed 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 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 generally 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 applicable to other charitable contributions of capital gain property.

Description of Proposal

The proposal provides that a taxpayer may exclude from income 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 is taxed as capital gain eligible for the alternative rate schedule of present law. The exclusion is computed without regard to improvements.

To be eligible for the exclusion, the taxpayer or a member of the taxpayer's family has to have owned the property for the three years immediately preceding the date of the sale. The taxpayer is not eligible for the exclusion in the case of property sold pursuant to a condemnation order, but the taxpayer is 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 is either a governmental unit or a charity that is a qualified organization under present-law section 170(h)(3) and that is organized and operated primarily for conservation purposes. Conservation purposes 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 must 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 organization in a transaction that would qualify under the proposal if the qualified conservation organization (i.e., the buyer in the transaction that is the subject of the written statement) were a taxable person.

Sales of partial interests in property also qualify if the sale meets the present law standards for qualified conservation contributions of partial interests within the meaning of section 170(h).

To prevent abuse, significant penalties are imposed on any subsequent transfer or use of the property other than exclusively for conservation purposes, or on any subsequent removal of a conservation restriction contained in an instrument of conveyance of the property. Sales of the property under the proposal at a price that is less than the fair market value of property qualify as bargain sales,[166] but only to the extent that the proceeds of the sale, net of capital gains taxes under this provision, are lower than the after-tax proceeds that would have resulted if the property had been sold at fair market value and the seller had paid tax on the full amount of the resulting gain.

Effective date.–The proposal is effective for sales occurring on or after January 1, 2005, and before January 1, 2008.

Analysis

Policy issues

In general, for sales of real estate, the maximum tax rate applied to capital gain income (excluding improvements) is 15 percent for taxpayers who would otherwise be in the 25 percent, 28 percent, 33 percent, and 35 percent ordinary income tax brackets.[167] 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 7.5 percent.[168] Per $1,000 of gain, the proposal could produce a benefit of up to $75 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price.[169] The proposal seeks to increase sales of conservation property to qualifying conservation organizations by making it possible for the seller to reap a higher after-tax return by selling 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

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[166] *See* Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

[167] Under present law, the maximum tax rate applied to capital gain income for taxpayers in the 10 and 15-percent income tax brackets is five percent (zero percent after 2007).

[168] In the case of a taxpayer otherwise in the 10-percent or 15-percent marginal income tax bracket, the result of the combination of the exclusion and the alternative five-percent tax rate on income from capital gain is an effective tax rate of 2.5 percent on the gain.

[169] In the case of a taxpayer otherwise in the 10-percent or 15-percent marginal income tax brackets, per $1,000 of gain, the proposal could produce a benefit of up to $25 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price.

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 knowing 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 calculations above, by lowering the effective tax rate, the Federal government would be effectively contributing as much as 7.5 percent of the purchase price of the property.[170]

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 depends 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 derive a substantial portion of the benefit of the lower effective tax rate. While the persons who are not 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 could 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 deriving 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.

The incentive effects of the proposal decrease as the capital gains tax rate decreases for the selling taxpayer, as is the case for many taxpayers as a result of the JGTRRA capital gain rate reductions.

Complexity issues

In its report,[171] 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

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[170] The percentages in the text assume 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, the comparable percentages would be lower.

[171] 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, 97-108, (JCS-3-01), April 2001.

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 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, those taxpayers who recognize other capital 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 organization 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's effective rate of tax may be less than 7.5 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 imposes 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 IRS 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.

The proposal also imposes additional complexity and record keeping burdens on the qualifying conservation organization because of the potential penalties that may be imposed for subsequent transfers or uses of the property that do not satisfy the conservation requirements. The organization likely will be required to retain records that demonstrate compliance with the proposal's requirements, and to notify the IRS if any impermissible change in use takes place with respect to the property. The IRS will have to modify its forms and instructions to provide for the imposition of the penalties in such cases. The application of modified bargain-sale rules to qualified conservation sales at a price less than fair market value also increases complexity for the buyer and seller of the property.

Prior Action

A similar proposal was included in the President's fiscal year 2002 and fiscal year 2003 budget proposals, which included less detail regarding the penalty and bargain-sale provisions, and in the President's fiscal year 2004 budget proposal.

A similar proposal was included in section 107 of S. 476, the "CARE Act of 2003," passed by the Senate on April 9, 2003, which would exclude 25 percent of long-term capital gain on certain sales or exchanges to eligible entities for conservation purposes.

H. Energy Provisions

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

Present Law[172]

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 1.8 cents per kilowatt hour for 2003. 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, 2004, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2004, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2004. 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).

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[172] 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 Job Creation and Worker Assistance Act of 2002 extended the placed in service date through December 31, 2003.

Description of Proposal

The proposal extends 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, 2007. The proposal does not extend the placed in service date for facilities that produce electricity from poultry waste.

The proposal expands the set of qualifying facilities to include facilities that produce electricity from qualifying open-loop biomass and open-loop biomass (but not closed-loop biomass) co-fired with coal. For these purposes open-loop biomass is defined as any solid, nonhazardous, cellulosic waste material that is segregated from other waste materials and 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 biomass facilities are any facility placed in service before January 1, 2007. In the case of facilities placed in service before January 1, 2004, taxpayers are eligible for credit for production from newly eligible sources from January 1, 2004 through December 31, 2008 (rather than ten years of production from the date the facility was placed in service) and the credit is equal to 60 percent of the otherwise allowable credit.

In the case of open-loop biomass co-fired with coal, qualifying facilities are any facility placed in service before January 1, 2007. Taxpayers producing electricity from such facilities will only be eligible to claim credit for electricity produced from newly eligible sources from January 1, 2004 though December 31, 2006 (rather than ten years of production from the date the facility was placed in service) and the credit will be at a rate equal to 30 percent of the otherwise allowable credit, regardless of the amount of open-loop biomass fuel burned with the coal.

The proposal also permits 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 modifies 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 is effective on the date of enactment.

Analysis

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

Prior Action

The President's fiscal year 2003 and 2004 budgets proposed a similar proposal to the current proposal (identical except for several effective dates). The President's fiscal year 2001 and 2002 budgets also proposed extending and expanding the categories of facilities that would qualify for the production credit under section 45.

The conference agreement to H.R. 6, "The Energy Policy Act of 2003," as passed by the House of Representatives on November 18, 2003, H.R. 6 as passed by the House of Representative on April 11, 2003, and S. 1149, as passed by the Senate on July 31, 2003, each contain a similar provision with respect to the extension of present-law section 45. Each bill would extend the production credit to open-loop biomass facilities. The conference agreement to H.R. 6 and S. 1149 would provide that certain facilities that co-fire closed-loop biomass with another fuel qualify for the production credit. In addition, the conference agreement to H.R. 6 and S. 1149 would extend the credit for poultry waste facilities. Also each bill defines further additional facilities, beyond open-loop biomass facilities, as qualifying for the production credit.

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 have extended the placed in service dates for wind facilities and closed-loop biomass facilities, but not poultry waste facilities. In addition, the House bill would have added two new types of qualifying facilities. Division H of H.R. 4, the "Energy Tax Incentives Act of 2002," as amended by the Senate on April 25, 2002, would have extended the placed in service date for all qualifying facilities and would have added eight new types of qualifying facilities.

2. Provide a 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 solar energy property.

Description of Proposal

The proposal provides a tax credit for the purchase of photovoltaic equipment and solar water heating equipment 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 is 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 is nonrefundable.

Effective date.–The credit applies to equipment placed in service after December 31, 2003 and before January 1, 2007 for solar water heating systems and after December 31, 2003 and before January 1, 2009 for photovoltaic systems.

Analysis

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

Prior Action

Similar proposals were contained in the President's fiscal year 1999-2004 budget proposals. The conference agreement to H.R. 6, "The Energy Policy Act of 2003," as passed by the House of Representatives on November 18, 2003 contained a similar provision. Similar provisions are contained in Division D of H.R. 6, the "Energy Tax Policy Act of 2003," as passed by the House of Representatives on April 11, 2003, and in Division H of H.R. 6, the "Energy Tax Incentives Act of 2003" as amended and passed by the Senate on July 31, 2003.

Similar provisions were also 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 in Division H of H.R. 4, "The Energy Tax Incentives Act of 2002," as amended and passed by the Senate on April 25, 2002.

3. Modify the 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.[173]

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 requirement").[174] 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

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[173] 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.

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

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.[175] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[176]

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.[177] 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.

Description of Proposal

Repeal of cost of service requirement

The proposal repeals 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 permits 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 is 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. Accordingly, if the transferor was not subject to tax and thus unable to use the deduction, then 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.

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

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

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

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

The proposal clarifies 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 provides that all nuclear decommissioning costs are deductible when paid.

Contributions to a qualified fund after useful life of powerplant

The proposal also allows deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments are 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 is effective for taxable years beginning after December 31, 2003.

Analysis

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.[178] If deregulation continues, the 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 allows 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 provides equal treatment to all decommissioning costs and provides 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 removes a tax barrier that may be hindering taxpayers from fulfilling various policy goals of electricity deregulation.

Complexity issues

Many aspects of the proposal 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.

Prior Action

An identical proposal was included in the President's fiscal year 2004 and 2003 budget proposal. A similar proposal was included in section 1328 of the Conference Report to H.R. 6, the "Energy Policy Act of 2003."

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

Present Law[179]

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 2004. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006. The credit rate is 7.5 percent and the maximum credit amount is $3,000 for 2004. There is no carry forward or carry back of the credit for electric vehicles.

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

[179] Code sections 30 and 179A were enacted as part of the Energy Policy Act of 1992 and were extended by the Job Creation and Worker Assistance Act of 2002.

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 a seating capacity 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. However, certain hybrid electric vehicles do qualify for the clean-fuel vehicle deduction. The deduction for clean-fuel vehicles phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006. The maximum value of the deduction for vehicles weighing less than 10,000 pounds is $1,500 for 2004.

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, 2006.

Description of Proposal

In general

The proposal provides a tax credit for the purchase of a qualified hybrid vehicle or fuel cell vehicle purchased after December 31, 2003 and before January 1, 2008 for a hybrid vehicle and after December 31,2003 and before January 1, 2013 for a fuel cell vehicle. The credits are available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers are able to claim only one of the credits per vehicle and taxpayers who claim either credit are not able to claim the qualified electric vehicle credit or the deduction for clean-fuel vehicles for the same vehicle. For business taxpayers the credit is part of the general business credit and the taxpayer will 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 is a motor vehicle that draws propulsion energy from on-board sources of stored energy which include both an 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 is 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 is 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 is 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	

<u>Fuel cell vehicles</u>

A qualifying fuel cell vehicle is 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 is $4,000 plus an additional credit determined by the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is 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.–Additional Fuel Economy Credit for 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 is the 2000 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" is 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 is effective for vehicles purchased after December 31, 2003.

Analysis

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

Prior Action

The President's fiscal year 2003 and 2004 budget proposals contained a similar proposal to the current proposal (identical except for effective dates). The President's fiscal year 1999, 2000, 2001, and 2002 budget proposals proposed creating a credit for electric and hybrid vehicles.

The conference agreement to H.R. 6, "The Energy Policy Act of 2003," as passed by the House of Representatives on November 18, 2003, and S. 1149, as passed by the Senate on

July 31, 2003, each contain a similar provision with respect to hybrid vehicles and fuel cell vehicles. H.R. 6 as passed by the House of Representative on April 11, 2003, contains a similar provision with respect to fuel cell vehicles, but not hybrid vehicles. In addition, each bill would extend present-law sections 179A and 30 (S. 1149 also modifies the section 30 credit).

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 have extended section 179A, would have extended and modified section 30, and would have provided new credits for the purchase of hybrid vehicles and fuel cell motor vehicles. Division H of H.R. 4, the "Energy Tax Incentives Act of 2002," as amended by the Senate on April 25, 2002, would have extended section 179A, would have extended and modified section 30, and would have provided new credits for the purchase of hybrid vehicles and fuel cell motor vehicles.

5. Provide a tax credit for energy produced from landfill gas

Present Law[180]

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 2002,[181] the inflation adjusted value of the credit was $6.35 per barrel of oil or barrel equivalent (*e.g.*, $1.12 per thousand cubic feet of natural gas[182]). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

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[180] 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.

[181] Under present law the indexed amount of credit applicable to production during a calendar year is not known until after the close of the calendar year. The Secretary generally publishes the indexed value of the credit for a calendar year in April of the subsequent year. Hence, the value of the credit for 2003 may be expected to be published in April 2004.

[182] 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.

(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).

Description of Proposal

The proposal extends the section 29 production credit for landfill gas if the gas is produced from a facility placed in service after December 31, 2003 and before January 1, 2012, and is sold (or used to make electricity) before January 1, 2012. In the case of any landfill, the proposal provides that the term "facility" includes 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, 2003 is treated as produced from the portion of the facility placed in service after that date. Thus, a landfill that opened to receive municipal solid waste prior to January 1, 2004, may have portions of the landfill placed in service after December 31, 2003, for purposes of claiming the section 29 credit.

In the case of gas produced at landfills subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines, the taxpayer is 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, 2004 in all other cases.

Effective date.–The proposal is effective on the date of enactment.

Analysis

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

Prior Action

The President's fiscal year 2003 and 2004 budgets proposed a similar proposal to the current proposal (identical except for certain placed in service dates and fuel production dates).

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

The conference agreement to H.R. 6, "The Energy Policy Act of 2003," as passed by the House of Representatives on November 18, 2003, H.R. 6 as passed by the House of Representative on April 11, 2003, and S. 1149, as passed by the Senate on July 31, 2003, each contain a similar provision with respect to landfill gas. In addition, each bill would reduce the amount of the credit per barrel of oil equivalent for gas from new facilities and limit the amount of gas eligible for credit from any facility.

Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, contained a similar provision with a reduced value of credit for landfill gas from newly qualifying facilities. Division H of H.R. 4, the "Energy Tax Incentives Act of 2002," as amended by the Senate on April 25, 2002, contained a similar provision with a reduced value of credit for landfill gas from newly qualifying facilities.

6. Provide a 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 establish a 10-percent investment credit for qualified CHP systems with an electrical capacity in excess of 50 kilowatts or with a capacity to produce mechanical power in excess of 67 horsepower (or an equivalent combination of electrical and mechanical energy capacities). CHP property is defined as property comprising a system that uses the same

energy source for the simultaneous or sequential generation of (1) electricity or mechanical shaft power (or both) and (2) steam or other forms of useful thermal energy (including heating and cooling applications). A qualified CHP system is required to produce at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof) and would also be required to satisfy an energy-efficiency standard. For CHP systems with an electrical capacity in excess of 50 megawatts (or a mechanical energy capacity in excess of 67,000 horsepower), the total energy efficiency of the system would have to exceed 70 percent. For smaller systems, the total energy efficiency would have to exceed 60 percent. For this purpose, total energy efficiency is calculated as the sum of the useful electrical, thermal, and mechanical power produced by the system at normal operating rates, measured on a Btu basis, divided by the lower heating value of the primary fuel source for the system. The eligibility of qualified CHP property is verified under regulations prescribed by the Secretary of the Treasury.

Qualified CHP assets that are assigned cost recovery periods of less than 15 years are eligible for the credit, but only if the taxpayer elects to treat such property as having a 22-year class life. Thus, for such property, regular tax depreciation allowances are calculated using a 15-year recovery period and the 150 percent declining balance method.

The credit is treated as an energy credit under the investment credit component of the section 38 general business credit, and is subject to the rules and limitations governing that credit. Taxpayers using the credit for CHP equipment would not be entitled to any other tax credit for the same equipment.

<u>Effective date</u>.–The credit would apply to equipment placed in service after December 31, 2003 and before January 1, 2009.

Analysis

See General discussion immediately below.

Prior Action

A similar proposal was contained in the President's fiscal year 2000, 2003 and 2004 budget proposals. The conference agreement to H.R. 6, “The Energy Policy Act of 2003,” as passed by the House of Representatives on November 18, 2003 contained a similar provision. Similar provisions are contained in Division D of H.R. 6, the "Energy Tax Policy Act of 2003," as passed by the House of Representatives on April 11, 2003, and in Division H of H.R. 6, the “Energy Tax Incentives Act of 2003” as amended and passed by the Senate on July 31, 2003.

Similar provisions were also 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 in Division H of H.R. 4, “The Energy Tax Incentives Act of 2002,” as amended and passed by the Senate on April 25, 2002.

Analysis for 1, 2, 4, 5, and 6.

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 8 percent of that return went to the investor, and 7 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 2 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 2 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.[183] 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 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

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[183] 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.

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.[184] 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 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

[184] 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.

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.

7. Extend excise tax exemption (credit) for ethanol

Present Law

Alcohol fuels income tax credit

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 52 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 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007. The credit is scheduled to expire after December 31, 2007.

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 for up to a maximum of 15 million gallons. Eligible small producers are defined as persons whose production capacity does not exceed 30 million gallons. This credit is scheduled to expire after December 31, 2007.

Excise tax reduction

Registered ethanol blenders may forgo the full income tax credit and instead pay reduced rates of excise tax on gasoline that they purchase for blending with ethanol. Most of the benefit of the alcohol fuels credit is claimed through the excise tax system.

The reduced excise tax rates apply only when gasoline is being purchased for the production of "gasohol." Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. The Federal excise tax on gasoline is 18.4 cents per gallon. For the calendar year 2003, the following reduced rates apply to gasohol:[185]

5.7 percent ethanol	15.436 cents per gallon
7.7 percent ethanol	14.396 cents per gallon
10.0 percent ethanol	13.200 cents per gallon

Description of Proposal

The President's budget proposal extends the present-law income tax credits and excise tax reduced rates for ethanol fuels, ethanol-blended fuels, methanol fuels, and methanol-blended fuels, for an additional three years, through December 31, 2010.

Effective date.–The proposal is effective on the date of enactment.

Analysis

Policy issues

The present-law tax credit for the production of ethanol is 52 cents per gallon of pure ethanol produced. Ethanol's price averages approximately $1.40 per gallon 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

[185] These special rates will terminate on September 30, 2007 (sec. 4081(c)(8)). In addition, the basic fuel tax rate will drop to 4.3 cents per gallon beginning on October 1, 2005.

imported, 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 seven percent of domestic corn production. In the absence of the tax subsidy, demand for corn would 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 2.13 billion gallons in 2002. 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 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 2001, the United States exported approximately 20 percent of corn produced and approximately 35 percent of soybean production.[186] 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.

<u>Complexity issues</u>

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

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[186] United States Department of Agriculture, *Agriculture Statistics* (2002).

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.

Additionally, ETBE, an ether produced using ethanol, may be blended by refiners before the 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 through September 30, 2003. A similar provision was included in H.R. 6, the Energy Policy Act of 2003, as passed by the Senate on July 31, 2003.

8. Allow deferral of gain on sales or dispositions to Implement Federal Energy Regulatory Commission or state electric restructuring policy

Present Law

Generally, a taxpayer recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller’s basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Description of Proposal

The proposal permits a taxpayer to elect to recognize gain from sales of electric transmission property to an independent transmission company ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase electric or gas utility property within an applicable period.[187]

In general, an independent transmission company is defined as: (1) any FERC-approved regional transmission organization, independent system operator, or independent transmission company; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a “market participant” and (ii) whose transmission facilities are placed under the operational control of a FERC-approved regional transmission organization, independent system operator, or independent transmission company; and (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which

[187] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of such an entity.

If a taxpayer elects the application of the proposal, then the statutory period for the assessment of any deficiency attributable to such gain shall not expire prior to the expiration of three years from the date the Secretary of the Treasury is notified by the taxpayer of the reinvestment property or an intention not to reinvest.

Effective date.–The proposal is effective to sales or other dispositions occurring after the date of enactment and before January 1, 2007.

Analysis

Policy issues

Electric deregulation has been occurring, and is continuing to occur, at both the Federal and State level. Federal and State energy regulators are calling for the "unbundling" of electric transmission assets held by vertically integrated utilities, with the transmission assets ultimately placed under the ownership or control of independent transmission providers (or other similarly-approved operators). This policy is intended to improve transmission management and facilitate the formation of competitive markets.

To facilitate the implementation of these policy objectives, the proponents assert it is appropriate to assist taxpayers in moving forward with industry restructuring by providing a tax deferral for gain associated with certain dispositions of electric transmission assets. In addition, because the proposal requires the proceeds of such dispositions to be reinvested in utility property the proponents argue that it will assist in modernizing our energy infrastructure. However, some may argue that providing special rules for certain industries and situations increases complexity and indirectly increases the tax burden on other taxpayers.

Complexity issues

The proposal permits gain to be recognized over an eight year period if the proceeds are reinvested within four years in certain utility property. The proposal would likely require additional effort and audit resources in auditing taxpayers that have undertaken a transaction eligible for the proposal. In addition, additional records and computations will be required by the taxpayer to properly reflect the tax basis in the reinvested utility property. However, the number of transactions eligible should not be significant and taxpayers likely to benefit from proposal will have the resources to comply with the additional records and computations necessary.

Prior Action

A similar proposal was included in section 1327 of the Conference Report to H.R. 6, the "Energy Policy Act of 2003."

9. Modify tax treatment of certain income of electric cooperatives

Present Law

In general

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not specified by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).[188]

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member of a cooperative.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code[189] are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[190] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

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[188] Announcement 96-24, "Proposed Examination Guidelines Regarding Rural Electric Cooperatives," 1996-16 I.R.B. 35.

[189] Sec. 1381, et seq.

[190] Sec. 1382.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative.[191]

Taxation of electric cooperatives exempt from subchapter T

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in section 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas."[192] Instead, electric cooperatives are taxed under rules that were applicable generally to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.[193]

Tax exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).[194] The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from the prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). The exclusion for cancellation of indebtedness income applies to such income arising in 1987, 1988, or 1989 on debt that either originated with, or is guaranteed by, the Federal Government.

Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under section 511.

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[191] Sec. 521.

[192] Sec. 1381(a)(2)(C).

[193] *See* Rev. Rul. 83-135, 1983-2 C.B. 149.

[194] Rev. Rul. 72-36, 1972-1 C.B. 151.

Description of Proposal

Treatment of income from open access transactions

The proposal provides that certain income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). Such income includes income that is received or accrued: (1) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under a tariff filed with the Federal Energy Regulatory Commission ("FERC")[195] or an independent transmission provider agreement approved or accepted by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities); or (2) from the provision or sale of open access distribution services (i) to deliver electricity to end-users served by distribution facilities not owned by the cooperative or any of its members, or (ii) to deliver to third parties electricity generated by a facility that is not owned or leased by the cooperative or any of its members and is directly connected to distribution facilities owned by the cooperative or any of its members.

Treatment of income from nuclear decommissioning transactions

The proposal provides that income received or accrued by a rural electric cooperative from any "nuclear decommissioning transaction" also is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "nuclear decommissioning transaction" is defined as: (1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear powerplant or nuclear powerplant unit; (2) any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or (3) any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

Treatment of income from asset exchange or conversion transactions

The proposal provides that gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This proposal only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to voluntary exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or methane-based natural gas.

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[195] Under the proposal, references to FERC are treated as including references to the Public Utility Commission of Texas.

Treatment of income from load loss transactions

Tax-exempt rural electric cooperatives

The proposal provides that income received or accrued by a tax-exempt rural electric cooperative from a "load loss transaction" is treated under 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to its members. Therefore, income from load loss transactions is treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The proposal also provides that income from load loss transactions does not cause a tax-exempt electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The term "load loss transaction" generally is defined as any wholesale or retail sale of electric energy (other than to a member of the cooperative) to the extent that the aggregate amount of such sales during a ten-year period beginning with the "start-up year" does not exceed the reduction in the amount of sales of electric energy during such period by the cooperative to members. The "start-up year" is defined as the first year that the cooperative offers nondiscriminatory open access or, if later and at the election of the cooperative, the calendar year that includes the date of enactment of the proposal.

The proposal also excludes income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business income.

Taxable electric cooperatives

The proposal provides that the receipt or accrual of income from load loss transactions by taxable electric cooperatives is treated as income from patrons who are members of the cooperative. Thus, income from a load loss transaction is excludible from the taxable income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a patron who is not a member of the cooperative. The proposal also provides that income from load loss transactions does not cause a taxable electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

Effective date

The proposal is effective for taxable years beginning after the date of enactment.

Analysis

Policy issues

Proponents of the proposal argue that the present-law rules for rural electric cooperatives should be modified to allow cooperatives to carry out their statutory purpose in a restructured competitive electric energy market environment without adversely impacting their tax-exempt status. Accordingly, the proposal relaxes the 85-percent member income test for rural electric

cooperatives in two ways. First, the proposal excludes from the test certain non-member income earned by a rural electric cooperative from the provision of certain transmission and distribution services if the cooperative enters a competitive electricity market by providing open access. Second, the proposal treats as member income, for purposes of the 85-percent test and for a 10-year period of time, income earned by a rural electric cooperative from the sale of electric energy to non-members to the extent that member income is lost following (but not necessarily as a result of) the entry of the cooperative into a competitive electricity market through the provision of open access.

While proponents believe that the proposals regarding open access and load loss transactions are necessary to the survival of rural electric cooperatives in a competitive market environment, opponents believe that the proposal would inappropriately facilitate the encroachment of electric cooperatives--with their competitive advantage of tax exemption--into energy markets already served by electric utilities that are subject to the corporate tax on their net income.[196] More generally, some may argue that the need for proposals to facilitate the participation of rural electric cooperatives in electricity markets that are competitive actually suggests that tax incentives (such as tax exemption) are no longer necessary to ensure the provision of electricity to such markets at reasonable rates.

The purpose of the 85-percent member income test for rural electric cooperatives is to ensure that the primary activities of a rural electric cooperative fulfill the statutory tax-exempt purpose of providing electricity services to the members of the cooperative. Similarly, the present-law fundamental cooperative principles described above are the defining characteristics of a cooperative upon which the Federal tax rules condition conduit treatment. Proposals to relax these requirements and principles tend to obscure the distinction between tax-exempt rural electric cooperatives and taxable electric utilities, thus diminishing the policy justifications for extending tax benefits (such as tax exemption) to companies that operate as rural electric cooperatives. Consequently, to the extent such proposals permit rural electric cooperatives to earn more income that otherwise would be taxable if earned by a taxable electric utility, they impair the tax policy objective of horizontal equity (*i.e.*, equal taxation of similarly situated taxpayers).

Certain provisions of the proposal, relating to nuclear decommissioning transactions and asset exchange or conversion transactions, do not raise significant policy issues and, as described below, tend to reduce the complexity of the Code by clarifying present law.

Complexity issues

In general, the proposals regarding open access and load loss transactions can be expected to add complexity to the Code. These proposals attempt to further certain non-tax policy objectives (i.e., electric industry restructuring) by permitting rural electric cooperatives to earn non-member income in limited circumstances without detrimentally impacting the ability of

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[196] While tax-exempt electric cooperatives generally are referred to as "rural" electric cooperatives, there is no statutory or administrative requirement limiting the operation of such cooperatives to any particular geographic area (rural or otherwise).

the cooperative to satisfy the 85-percent member income requirement for tax exemption. The proposals define these circumstances with a series of rules that are complex and incorporate several new terms of art from the electric industry that have no precedent in the tax laws (*e.g.*, "open access").

However, the proposal can be expected to reduce complexity with regard to the provisions concerning nuclear decommissioning transactions and asset exchange or conversion transactions. These provisions would resolve some ambiguity that exists in present law with regard to whether gross income from such transactions is non-member income under the 85-percent test.

Prior Action

The conference agreement to H.R. 6, "The Energy Policy Act of 2003," as passed by the House of Representatives on November 18, 2003, H.R. 6 as passed by the House of Representative on April 11, 2003, and S. 1149, as passed by the Senate on July 31, 2003, each contain provisions similar to the proposal.

III. SIMPLIFY THE TAX LAWS FOR FAMILIES

A. Establish Uniform Definition of a Qualifying Child

Present Law

In general

Present law contains five commonly used provisions that provide benefits to taxpayers with children: (1) the dependency exemption; (2) the child credit; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. Each provision has separate criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child. The separate criteria include factors such as the relationship (if any) the child must bear to the taxpayer, the age of the child, and whether the child must live with the taxpayer. Thus, a taxpayer is required to apply different definitions to the same individual when determining eligibility for these provisions, and an individual who qualifies a taxpayer for one provision does not automatically qualify the taxpayer for another provision.

Dependency exemption[197]

In general

Taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. For 2004, the amount deductible for each personal exemption is $3,100. The deduction for personal exemptions is phased out for taxpayers with incomes above certain thresholds.[198]

In general, a taxpayer is entitled to a dependency exemption for an individual if the individual: (1) satisfies a relationship test or is a member of the taxpayer's household for the entire taxable year; (2) satisfies a support test; (3) satisfies a gross income test or is a child of the taxpayer under a certain age; (4) is a citizen or resident of the U.S. or resident of Canada or Mexico;[199] and (5) did not file a joint return with his or her spouse for the year.[200] In addition, the taxpayer identification number of the individual must be included on the taxpayer's return.

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[197] Secs. 151 and 152. Under the statutory structure, section 151 provides for the deduction for personal exemptions with respect to "dependents." The term "dependent" is defined in section 152. Most of the requirements regarding dependents are contained in section 152; section 151 contains additional requirements that must be satisfied in order to obtain a dependency exemption with respect to a dependent (as so defined). In particular, section 151 contains the gross income test, the rules relating to married dependents filing a joint return, and the requirement for a taxpayer identification number. The other rules discussed here are contained in section 151.

[198] Sec. 151(d)(3).

[199] A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a dependent (provided other applicable requirements are met) if (1)

Relationship or member of household test

Relationship test.–The relationship test is satisfied if an individual is the taxpayer's (1) son or daughter or a descendant of either (e.g., grandchild or great-grandchild); (2) stepson or stepdaughter; (3) brother or sister (including half brother, half sister, stepbrother, or stepsister); (4) parent, grandparent, or other direct ancestor (but not foster parent); (5) stepfather or stepmother; (6) brother or sister of the taxpayer's father or mother; (7) son or daughter of the taxpayer's brother or sister; or (8) the taxpayer's father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

An adopted child (or a child who is a member of the taxpayer's household and who has been placed with the taxpayer for adoption) is treated as a child of the taxpayer. A foster child is treated as a child of the taxpayer if the foster child is a member of the taxpayer's household for the entire taxable year.

Member of household test.–If the relationship test is not satisfied, then the individual may be considered the dependent of the taxpayer if the individual is a member of the taxpayer's household for the entire year. Thus, a taxpayer may be eligible to claim a dependency exemption with respect to an unrelated child who lives with the taxpayer for the entire year.

For the member of household test to be satisfied, the taxpayer must both maintain the household and occupy the household with the individual.[201] A taxpayer or other individual does not fail to be considered a member of a household because of "temporary" absences due to special circumstances, including absences due to illness, education, business, vacation, and military service.[202] Similarly, an individual does not fail to be considered a member of the taxpayer's household due to a custody agreement under which the individual is absent for less than six months.[203] Indefinite absences that last for more than the taxable year may be considered "temporary." For example, the IRS has ruled that an elderly woman who was indefinitely confined to a nursing home was temporarily absent from a taxpayer's household. Under the facts of the ruling, the woman had been an occupant of the household before being confined to a nursing home, the confinement had extended for several years, and it was possible that the woman would die before becoming well enough to return to the taxpayer's household.

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the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States. Sec. 152(b)(3).

[200] This restriction does not apply if the return was filed solely to obtain a refund and no tax liability would exist for either spouse if they filed separate returns. Rev. Rul. 54-567, 1954-2 C.B. 108.

[201] Treas. Reg. sec. 1.152-1(b).

[202] *Id.*

[203] *Id.*

There was no intent on the part of the taxpayer or the woman to change her principal place of abode.[204]

Support test

In general.–The support test is satisfied if the taxpayer provides over one half of the support of the individual for the taxable year. To determine whether a taxpayer has provided more than one half of an individual's support, the amount the taxpayer contributed to the individual's support is compared with the entire amount of support the individual received from all sources, including the individual's own funds.[205] Governmental payments and subsidies (e.g., Temporary Assistance to Needy Families, food stamps, and housing) generally are treated as support provided by a third party. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. If any person furnishes support in kind (e.g., in the form of housing), then the fair market value of that support must be determined.

Multiple support agreements.–In some cases, no one taxpayer provides more than one half of the support of a individual. Instead, two or more taxpayers, each of whom would be able to claim a dependency exemption but for the support test, together provide more than one half of the individual's support. If this occurs, the taxpayers may agree to designate that one of the taxpayers who individually provides more than 10 percent of the individual's support can claim a dependency exemption for the child. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the taxpayer who claims the exemption.

Special rules for divorced or legally separated parents.–Special rules apply in the case of a child of divorced or legally separated parents (or parents who live apart at all times during the last six months of the year) who provide over one half the child's support during the calendar year.[206] If such a child is in the custody of one or both of the parents for more than one half of the year, then the parent having custody for the greater portion of the year is deemed to satisfy the support test; however, the custodial parent may release the dependency exemption to the noncustodial parent by filing a written declaration with the IRS.[207]

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[204] Rev. Rul. 66-28, 1966-1 C.B. 31.

[205] In the case of a son, daughter, stepson, or stepdaughter of the taxpayer who is a full-time student, scholarships are not taken into account for purposes of the support test. Sec. 152(d).

[206] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child or foster child, or child placed with the taxpayer for adoption). Sec. 152(e)(1)(A).

[207] Special support rules also apply in the case of certain pre-1985 agreements between divorced or legally separated parents. Sec. 152(e)(4).

Gross income test

In general, an individual may not be claimed as a dependent of a taxpayer if the individual has gross income that is at least equal to the personal exemption amount for the taxable year.[208] If the individual is the child of the taxpayer and under age 19 (or under age 24, if a full-time student), the gross income test does not apply.[209] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child of the taxpayer, a foster child who resides with the taxpayer for the entire year, or a child placed with the taxpayer for adoption by an authorized adoption agency).

Earned income credit[210]

In general

In general, the earned income credit is a refundable credit for low-income workers. The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no "qualifying children." In order to be a qualifying child for the earned income credit, an individual must satisfy a relationship test, a residency test, and an age test. In addition, the name, age, and taxpayer identification number of the qualifying child must be included on the return.

Relationship test

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son, daughter, stepson, or stepdaughter, or a descendant of any such individual;[211] (2) brother, sister, stepbrother, or stepsister, or a descendant of any such individual, who the taxpayer cares for as the taxpayer's own child; or (3) eligible foster child. An eligible foster child is an individual (1) who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of

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[208] Certain income from sheltered workshops is not taken into account in determining the gross income of permanently and totally disabled individuals. Sec. 151(c)(5).

[209] Sec. 151(c). The IRS has issued guidance stating that for purposes of the dependency exemption, an individual attains a specified age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004). Rev. Rul. 2003-72, 2003-33 I.R.B. 346.

[210] Sec. 32. A separate proposal of the President's 2005 budget proposal would modify certain requirements regarding the earned income credit in an attempt to simplify the credit with respect to certain taxpayers. Such modifications include allowing certain separated spouses to claim the credit, simplifying the rules regarding the presence of a qualifying child for taxpayers in extended family situations, eliminating the disqualified investment income test, and clarifying when a social security number is a valid TIN for earned income credit purposes.

[211] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.[212]

Residency test

The residency test is satisfied if the individual has the same principal place of abode as the taxpayer for more than one half of the taxable year. The residence must be in the United States.[213] As under the dependency exemption (and head of household filing status), temporary absences due to special circumstances, including absences due to illness, education, business, vacation, and military service are not treated as absences for purposes of determining whether the residency test is satisfied.[214] Under the earned income credit, there is no requirement that the taxpayer maintain the household in which the taxpayer and the qualifying individual reside.

Age test

In general, the age test is satisfied if the individual has not attained age 19 as of the close of the calendar year.[215] In the case of a full-time student, the age test is satisfied if the individual has not attained age 24 as of the close of the calendar year. In the case of an individual who is permanently and totally disabled, no age limit applies.

Child credit[216]

Taxpayers with incomes below certain amounts are eligible for a child credit for each qualifying child of the taxpayer. The amount of the child credit is up to $1,000, in the case of taxable years beginning in 2003 or 2004. The child credit is $700 for taxable years beginning in 2005 through 2008, $800 for taxable years beginning in 2009, and $1,000 for taxable years

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[212] Sec. 32(c)(3)(B)(ii).

[213] The principal place of abode of a member of the Armed Services is treated as in the United States during any period during which the individual is stationed outside the United States on active duty. Sec. 32(c)(4).

[214] IRS Publication 596, *Earned Income Credit (EIC)*, at 14. H. Rep. 101-964 (October 27, 1990), at 1037.

[215] The IRS has issued guidance stating that for purposes of the earned income credit, an individual attains a specified age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004). Rev. Rul. 2003-72, 2003-33 I.R.B. 346.

[216] Sec. 24.

beginning in 2010.[217] The credit declines to $500 in taxable year 2011.[218] For purposes of this credit, a qualifying child is an individual: (1) with respect to whom the taxpayer is entitled to a dependency exemption for the year; (2) who satisfies the same relationship test applicable to the earned income credit; and (3) who has not attained age 17 as of the close of the calendar year.[219] In addition, the child must be a citizen or resident of the United States.[220] A portion of the child credit is refundable under certain circumstances.[221]

Dependent care credit[222]

The dependent care credit may be claimed by a taxpayer who maintains a household that includes one or more qualifying individuals and who has employment-related expenses. A qualifying individual means (1) a dependent of the taxpayer under age 13 for whom the taxpayer is entitled to a dependency exemption,[223] (2) a dependent of the taxpayer who is physically or

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[217] A separate proposal contained in the President's fiscal year 2005 budget proposal (extending through 2010 certain provisions of the 2003 Jobs and Growth Tax Cut) extends the $1,000 credit amount through 2010.

[218] Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. No. 107-16, sec. 901(a) (2001) (making, by way of the EGTRRA sunset provision, the increase in the child credit inapplicable to taxable years beginning after December 31, 2010). A separate proposal contained in the President's fiscal year 2005 budget proposal (permanently extending certain provisions of the 2001 Tax Cut and the 2003 Jobs Growth and Tax Cut) makes permanent the $1,000 credit amount after 2010.

[219] The IRS has issued guidance stating that for purposes of the child credit, an individual attains a specified age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004). Rev. Rul. 2003-72, 2003-33 I.R.B. 346.

[220] The child credit does not apply with respect to a child who is a resident of Canada or Mexico and is not a U.S. citizen, even if a dependency exemption is available with respect to the child. Sec. 24(c)(2). The child credit is, however, available with respect to a child dependent who is not a resident or citizen of the United States if: (1) the child has been legally adopted by the taxpayer; (2) the child's principal place of abode is the taxpayer's home; and (3) the taxpayer is a U.S. citizen or national. *See* sec. 24(c)(2) and sec. 152(b)(3).

[221] Sec. 24(d).

[222] Sec. 21.

[223] The IRS has issued guidance stating that for purposes of the dependent care credit, an individual attains a specified age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004). Rev. Rul. 2003-72, 2003-33 I.R.B. 346.

mentally incapable of caring for himself or herself,[224] or (3) the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself. In addition, a taxpayer identification number for the qualifying individual must be included on the return.

A taxpayer is considered to maintain a household for a period if over one half the cost of maintaining the household for the period is furnished by the taxpayer (or, if married, the taxpayer and his or her spouse). Costs of maintaining the household include expenses such as rent, mortgage interest (but not principal), real estate taxes, insurance on the home, repairs (but not home improvements), utilities, and food eaten in the home.

A special rule applies in the case of a child who is under age 13 or is physically or mentally incapable of caring for himself or herself if the custodial parent has waived his or her dependency exemption to the noncustodial parent.[225] For the dependent care credit, the child is treated as a qualifying individual with respect to the custodial parent, not the parent entitled to claim the dependency exemption.

Head of household filing status[226]

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half of the year of (1) an unmarried son, daughter, stepson or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son or daughter, (2) an individual described in (1) who is married, if the taxpayer may claim a dependency exemption with respect to the individual (or could claim the exemption if the taxpayer had not waived the exemption to the noncustodial parent), or (3) a relative with respect to whom the taxpayer may claim a dependency exemption.[227] If certain other requirements are satisfied, head of household filing status also may be claimed if the taxpayer is entitled to a dependency exemption with respect to one of the taxpayer's parents.

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[224] Although such an individual must be a dependent of the taxpayer as defined in section 152, it is not required that the taxpayer be entitled to a dependency exemption with respect to the individual under section 151. Thus, such an individual may be a qualifying individual for purposes of the dependent care credit, even though the taxpayer is not entitled to a dependency exemption because the individual does not meet the gross income test.

[225] Sec. 21(e)(5).

[226] Sec. 2(b).

[227] Sec. 2(b)(1)(A)(ii), as qualified by sec. 2(b)(3)(B). An individual for whom the taxpayer is entitled to claim a dependency exemption by reason of a multiple support agreement does not qualify the taxpayer for head of household filing status. A separate proposal contained in the President's budget proposal repeals the present-law requirement that the taxpayer provide over one half the cost of maintaining the household.

Description of Proposal

Detailed description of proposal

In general

The proposal establishes a uniform definition of qualifying child for purposes of the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. A taxpayer could continue to claim an individual who does not meet the proposed uniform definition of qualifying child as a dependent if the present-law dependency requirements are satisfied. The proposal does not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children qualify for each tax benefit.[228]

Under the proposed uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode in the United States as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Under the proposal, the present-law support and gross income tests do not apply to a child who meets the requirements of the uniform definition of qualifying child.

The proposal eliminates the household maintenance test with respect to the dependent care credit.

Residency test

Under the proposed residency test, a child must have the same principal place of abode in the United States as the taxpayer for more than one half the taxable year. As under present-law rules, temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, would not be treated as absences. Military personnel on extended active duty outside the United States would be considered to be residing in the United States.

Relationship test

In order to be a qualifying child under the proposal, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. A foster child who is placed with the taxpayer by an authorized placement agency is treated as the taxpayer's child. If the child is the taxpayer's sibling or stepsibling or a descendant of any such individual, the taxpayer must care for the child as if the child were his or her own child.

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[228] Separate proposals of the President's budget proposal, however, modify certain of the rules relating to the child credit, the earned income credit, and the head of household filing status.

Age test

Under the proposal, the age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) in order to be a qualifying child. In general, no age limit applies with respect to individuals who are totally and permanently disabled. The proposal retains the present-law requirements that a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit, and under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

Under the proposal, a child who provides over one half of his or her own support is not considered a dependent of another taxpayer.

Tie-breaking rules

If a child would be a qualifying child with respect to more than one individual (e.g., a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time, and second with respect to the parent with the highest adjusted gross income. Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

Interaction with present-law rules

Taxpayers may continue to claim an individual who does not meet the proposed uniform definition of qualifying child as a dependent if the present-law dependency requirements are satisfied. Thus, for example, a taxpayer may claim a parent as a dependent if the taxpayer provides more than one half of the support of the parent and the parent's gross income is less than the exemption amount. As another example, as is the case under present law, taxpayers may claim an unrelated child as a dependent if the child resides in the taxpayer's home for the full year and meets the present-law dependency requirements.[229] If one taxpayer claims a child as a dependent under present law, and another taxpayer claims the same child as a dependent under the proposed uniform definition of qualifying child, the proposal provides that the proposed residency-based tests supersede present law.

The present-law dependency tests continue to apply to children who are U.S. citizens living abroad or non-U.S. citizens living in Canada or Mexico.

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[229] The proposal retains the present-law rule that such children would not qualify the taxpayer for the child credit or the earned income credit unless they were placed in the taxpayer's home by an authorized placement agency.

Children of divorced or legally separated parents

The proposal repeals the present-law provision that allows a custodial parent to release the claim to a dependency exemption (and, by extension, the child credit) to a noncustodial parent. The proposal provides a grandfather rule for a child support instrument between parents that applies to the dependent and that is in effect as of the date of the announcement of proposed legislation establishing a uniform definition of a qualifying child, and permits a waiver of the dependency exemption and child credit in such cases.

Other provisions

A child is not considered a qualifying child unless a taxpayer identification number for the child is provided on the taxpayer's return. For purposes of the earned income credit, a qualifying child is required to have a social security number that is valid for employment in the United States (that is, the child must be a U.S. citizen, permanent resident, or have a certain type of temporary visa).[230]

Effect of proposal on particular provisions

Dependency exemption

Under the proposed uniform definition of qualifying child, the proposal eliminates the support test (other than in the case of a child who provides more than one half of his or her own support), and replaces it with the residency requirement described above. Further, the present-law gross income test does not apply to a qualifying child. The rules relating to multiple support agreements do not apply with respect to qualifying children because the support test does not apply to them. Special tie-breaking rules (described above) apply if more than one taxpayer claims a qualifying child as a dependent under the proposal. These tie-breaking rules do not apply if a child constitutes a qualifying child with respect to multiple taxpayers, but only one eligible taxpayer actually claims a dependency exemption for the qualifying child.

The proposal permits taxpayers to continue to apply the present-law dependency exemption rules to claim a dependency exemption for an individual who does not satisfy the proposed qualifying child definition. This creates the possibility that multiple taxpayers could claim a dependency exemption for the same individual, one taxpayer using the present-law support test, and the other using a present-law residency-based test (e.g., if the child resides in the taxpayer's home for the full year and otherwise meets the present-law dependency tests). To address such cases, the proposal provides that if multiple taxpayers claim the same child, the proposed residency-based tests supersede present law.

As is the case under present law, a child who provides over half of his or her own support is not considered a dependent of another taxpayer under the proposal.

[230] A separate proposal of the President's budget proposal clarifies the requirements regarding a social security number that constitutes a valid TIN for earned income credit purposes.

The proposal repeals the present-law provision that allows a custodial parent to release the claim to a dependent exemption (and, by extension, the child credit) to a noncustodial parent, except in those cases where there exists a child support instrument between parents that applies to the dependent and that is in effect as of the date of the announcement of proposed legislation establishing a uniform definition of a qualifying child.

The proposal eliminates the present-law requirement that a foster child live with the taxpayer for the entire year.

Earned income credit

In general, the proposal adopts a definition of qualifying child that is similar to the present-law definition under the earned income credit. The present-law requirement that a foster child be cared for as the taxpayer's own child is eliminated. The present-law tie-breaker rule applicable to the earned income credit is used for purposes of the proposed uniform definition of qualifying child.

Child credit

The present-law child credit generally uses the same relationships to define an eligible child as the proposed uniform definition. The present-law requirement that a foster child be cared for as the taxpayer's own child is eliminated, as is the present-law requirement that a foster child live with the taxpayer for the entire year. The age limitation under the proposal retains the present-law requirement that the child must be under age 17, regardless of whether the child is disabled.

Dependent care credit

The requirement that a taxpayer maintain a household in order to claim the dependent care credit is eliminated. Thus, if other applicable requirements are satisfied, a taxpayer may claim the dependent care credit with respect to a child who lives with the taxpayer for more than one half the year, even if the taxpayer does not provide more than one half of the cost of maintaining the household.

The rules for determining eligibility for the credit with respect to individuals other than children remain as under present law.

Head of household filing status

Under the proposal, a taxpayer qualifies for head of household filing status with respect to a child who is a qualifying child as defined under the proposal. An individual who is not a qualifying child will qualify the taxpayer for head of household status only if, as is the case under present law, the individual is a dependent of the taxpayer and the taxpayer is entitled to a dependency exemption for such individual, or the individual is the taxpayer's father or mother and certain other requirements are satisfied. Thus, under the proposal a taxpayer is eligible for head of household filing status only with respect to a qualifying child or an individual for whom the taxpayer is entitled to a dependency exemption.

A separate proposal contained in the President's budget proposal repeals the present-law requirement that the taxpayer provide over one half the cost of maintaining the household.

Effective date

The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Complexity issues

In general

For many taxpayers, the issue of whether a child qualifies for one or more of the present-law child-related tax benefits is relatively straightforward and does not raise significant complexity issues. However, the use of different tests to determine whether a taxpayer may claim various tax benefits relating to children has long been recognized as a source of complexity for a significant number of taxpayers and the IRS.[231] Under present law, in order to determine whether a child qualifies a taxpayer for each of the relevant provisions, the taxpayer must apply up to five different tests (in addition to applying the other rules applicable to the particular provision). In IRS Publication 17, *Your Federal Income Tax (for Individuals)*, the explanations of whether a child qualifies under each of these provisions total approximately 38 pages,[232] comprised of the following:

- Dependency exemption: nine pages, including one flowchart for use in determining whether someone is a dependent, a worksheet for use in applying the support test, and one flowchart for use in determining the support test for children of divorced or separated parents;[233]

- Earned income credit: thirteen pages, including a chart illustrating the definition of qualifying child, an eligibility checklist, and a description of 15 separate rules applicable to the credit (seven that apply to all claimants, three that apply to claimants

[231] *See, e.g.,* 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, 44-66 (JCS-3-01), April 2001. *See also* American Bar Association, American Institute of Certified Public Accountants Tax Division and the Tax Executives Institute; American Bar Association Section of Taxation, Government Submissions, *available at* http://www.abanet.org/tax/pubpolicy/2001/01simple/home.html.

[232] The page number total has increased from 17 pages since the Joint Committee on Taxation simplification study was released in April 2001. The page number total nearly doubled from 2002 to 2003, with the increase attributable to the earned income credit (an additional 10 pages), the child credit (an additional three pages), and the dependent care credit (an additional six pages).

[233] IRS Publication 17, *Your Federal Income Tax (for Individuals)*, 28-36.

with a qualifying child, and five that apply to claimants without a qualifying child);[234]

- Child credit: four pages;[235]

- Dependent care credit: ten pages, including a flow chart for use in determining eligibility for the credit, and a flow chart for determining whether a child of divorced or separated parents qualifies the taxpayer for the credit;[236]

- Head of household filing status: two pages, including a chart illustrating the requirements for head of household filing status.[237]

In addition, there is a separate IRS publication for the earned income credit (Publication 596), which includes a seven-page description of the rules relating to qualifying children.[238]

The rules relating to qualifying children are a source of errors for taxpayers both because the rules for each provision are different and because of the complexity of particular rules.

Complexity due to varying rules

The variety of present-law rules cause taxpayers inadvertently to claim tax benefits for which they do not qualify as well as to fail to claim tax benefits for which they do qualify. For example, a taxpayer who is entitled to a dependency exemption with respect to a child whom the taxpayer supports but with whom the taxpayer does not live may erroneously believe that the taxpayer also is eligible for the earned income credit with respect to the child.[239] As another

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[234] *Id.* at 254-266.

[235] *Id.* at 244-247.

[236] *Id.* at 227-236.

[237] *Id.* at 25-27.

[238] IRS Publication 596, *Earned Income Credit (EIC)*, 11-17.

[239] The President's budget proposal states that a recent earned income tax credit compliance study found that nearly one in five children who were claimed as dependents and as earned income credit qualifying children in 1999 were disallowed for one, but not both, of these tax benefits. In a study of earned income credit compliance for credits claimed on 1997 returns, the IRS reported that the single largest amount of overclaims of the earned income credit--about 22 percent--was due to claiming the credit with respect to children who did not meet the eligibility requirement for a qualifying child. The IRS attributed most of these errors to taxpayers claiming children who did not meet the residency requirements. Department of the Treasury, Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (September 2000), at 10. In its more recent study of earned income credit compliance with respect to credits claimed on 1999 returns, the IRS estimated that approximately 25 percent of the overclaims of the earned income credit for which the type of

example, consider a custodial parent who has waived the dependency exemption under the rules relating to divorced and separated parents. The taxpayer may erroneously believe that ineligibility for the dependency exemption and the child tax credit as a result of the waiver extends to the earned income credit and head of household filing status. Moreover, the support tests and maintenance of household tests are similar, but not identical. The former test seeks to determine the amount of support for a particular individual, whereas the latter looks to a household. The kinds of expenses taken into account under each test are different; a taxpayer may inadvertently believe that satisfying one test satisfies the other.

The different rules regarding qualifying children have been identified as a source of complexity for taxpayers for over a decade. For example, in 1989, the American Bar Association recommended that the dependency exemption be replaced with a residency requirement and that the rules regarding qualifying children for the earned income credit and head of household filing status be conformed. The American Bar Association and the American Institute of Certified Public Accountants continue to advocate a similar proposal. The Commissioner of Internal Revenue identified filing status definitions, including those relating to dependents, as major sources of complexity.[240] Because these provisions affect so many taxpayers, the Commissioner's report concludes that "any complexity in the Code around filing definitions can result in prodigious overall burden."[241] The National Taxpayer Advocate has proposed applying a residency test to the definition of child dependent as well as the earned income credit in legislative recommendations for fiscal years 1997, 1998, 1999, 2000, and 2001. The staff of the Joint Committee on Taxation included proposals regarding a uniform definition of qualifying child in its simplification study released in April 2001.[242] In addition to these various proposals, comments have been provided by certain of these organizations and others in response to legislative proposals recently introduced in Congress.

Adopting a uniform definition of qualifying child achieves simplification by making it easier for taxpayers to determine whether they qualify for the various tax benefits relating to children. Adopting a uniform definition should reduce inadvertent taxpayer errors arising from

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error was known was attributable to claiming a child who was not a qualifying child. Department of the Treasury, Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (February 2002), at 13. Although there may be varying reasons for such failures, one source may be the erroneous belief that the person entitled to the dependency exemption is also entitled to the earned income credit (i.e., a failure to recognize the separate residency requirement for earned income credit as compared to the support test for the dependency exemption).

[240] Department of the Treasury, Internal Revenue Service, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity* (June 5, 2000), at 13.

[241] *Id.*

[242] 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, 44-66 (JCS-3-01), April 2001.

confusion due to differing definitions of qualifying child. A uniform definition also makes the applicable provisions easier for the IRS to administer.

Complexity of specific rules

In general.–Certain of the rules for each tax benefit are themselves complex. In particular, the support test for the dependency exemption (and by extension, the child credit) and separate maintenance of household tests for the dependent care credit and head of household filing status can require significant information gathering and calculations by the taxpayer. In some cases, it may be extremely difficult for the taxpayer to correctly apply these tests, because the taxpayer may require information not readily available (or even inaccessible), such as support provided by third parties and government subsidies.

Residency and support tests.–A definition of child or qualifying child for child-related tax benefits must include factors other than age and relationship. Failure to do so would create unnecessarily numerous multiple claimants to the same tax benefits, and award tax benefits to taxpayers without regard to who bears the economic and other burdens associated with raising a child. Support and residency tests oftentimes are regarded as the most feasible alternatives for this purpose.

Many argue that a residency test is easier to apply than a support test. A support test generally involves calculations that do not arise under a residency test, [243] and taxpayers may not know whether they have provided over one half the support of another individual.[244] In some cases, however, both tests present difficult issues. Replacing the support test with a residency test may place additional emphasis on counting days in certain circumstances in which more than one half year of residency is not clearly satisfied with respect to the taxpayer. For this reason, some have argued that guidance will be required with respect to the residency test, such as safe harbors or rebuttable presumptions that taxpayers could rely upon without having to count the precise number of days the child resided with the taxpayer.

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[243] The present-law dependency exemption support test generally requires the completion of a 22-line worksheet, contained in IRS Publication 17, Your Federal Income Tax, and IRS Publication 501, Exemptions, Standard Deduction, and Filing Information. The President's budget proposal states that a 1993 General Accounting Office study found that in 1988, taxpayers erroneously claimed dependency exemptions for an estimated nine million individuals, and that failing to satisfy the support test was the cause in nearly 75 percent of these cases. Of those failures to satisfy the support test, 57 percent involved a failure to provide sufficient financial support, and the remainder involved a lack of adequate records to demonstrate satisfaction of the support test.

[244] Some argue that this is especially the case if the taxpayer receives public benefits, which under present law are treated as support provided by a third party rather than by the taxpayer. Schenk, Deborah H., *Old Wine in Old Bottles: Simplification of Family Status Tax Issues*, presented at the NYU/Tax Analysts Government Tax Policy Workshop, Tax Code Complexity (February 9, 2001), published in Tax Notes, Vol. 91, No. 9 (May 28, 2001), 1437, 1449.

Further, adopting a residency test places additional pressure on the definition of temporary absence. Determining whether an absence is temporary can be difficult for taxpayers, because there is little published guidance and the issue is inherently a factual determination that may hinge on intent, which is difficult to demonstrate.

Replacing the present-law support test with a residency test also creates the need for tie-breaking rules that may increase complexity. Because only one taxpayer may provide over one half of a child's support, there is no need for a tie-breaker rule to allocate the tax benefit to one of multiple claimants when support is the determining factor. The proposed residency test may be satisfied with respect to a particular child by two or more taxpayers (e.g., a child who satisfies the age and relationship tests may reside in the same principal place of abode with two or more taxpayers, such as a female child living in the same principal place of abode as her mother and grandmother). The proposal provides a tie-breaker rule to address such cases where multiple taxpayers actually claim the same child, but requires the IRS to apply rules regarding adjusted gross income and length of residency to allocate the child to a single taxpayer.

The staff of the Joint Committee on Taxation concluded that a support test would be more difficult to apply than a residency test.[245] The proposal generally adopts the residency test for the uniform definition of qualifying child, but retains the support test for individuals who provide over one half of their own support.

Relationship test.–The proposal provides that certain individuals (a taxpayer's sibling or stepsibling or a descendant of any such individual) may not constitute a qualifying child unless the taxpayer cares for that individual as the taxpayer's own child. Some argue that this "care for" requirement is vague and hard to administer, and introduces a type of support test into the definition of qualifying child because it will require a showing of activities such as purchasing food, clothing, medical care, and other items. Others argue that a standard such as the "care for" test is required in certain family situations, such as those where there are siblings residing together without a parent, to determine which of the siblings should be entitled to claim the other sibling as a qualifying child.

Age test.–The proposal adopts a uniform age rule for purposes of the dependency exemption, the earned income credit, and head of household filing status, but retains the present-law age differences for child credit (under age 17) and the dependent care credit (under age 13 if not disabled). Many argue that determining a child's age generally is not difficult to do, and that differences in age rules that are justifiable on policy grounds or because of revenue constraints do not introduce significant complexity.

Interaction with present-law rules and taxpayer selectivity.–The proposal permits taxpayers who are eligible to claim the same individual as a qualifying child to choose which taxpayer will claim the dependency exemption with respect to the qualifying child, so long as only one taxpayer actually claims that qualifying child. Although permitting taxpayers to choose

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[245] 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, 52-53 (JCS-3-01), April 2001.

amongst themselves in certain instances increases flexibility for taxpayers, the existence of choice may increase planning and compliance complexity for such taxpayers.

Policy issues

In general

The primary objective of the proposal is to simplify the tax law pertaining to child-related tax benefits. The proposal raises several important policy issues, however, that are separate from its simplification goals. The most significant of these policy concerns generally involve questions of which taxpayer should be entitled to the relevant child-related tax benefits, the expansion or shifting of tax benefits as a result of the changes to present law made by the proposal, and the treatment of children of divorced or separated parents.

Expansion or shifting of tax benefits under the proposal

Residency and support tests.–The selection of residency or support as a determinant of who is entitled to certain child-related tax benefits raises policy issues separate from complexity. Many argue that child-related tax benefits should inure to those individuals who bear the greatest economic and other burdens associated with raising the child. That is, at least in part, the rationale for present-law rules that allocate dependency exemptions and certain other tax benefits to taxpayers who provide over one half of the individual's support or cost of maintaining the household. There is, however, no uniform definition of "support" within the tax law (i.e., the support test used for the dependency exemption and the child credit differs from the household maintenance test used for other purposes). Some believe that residency is a reasonable proxy for support because the cost of providing a residence is oftentimes the largest component of a child's support. Some have argued that a residency test is less open to abuse than a support test, because it generally is easier to determine when the residency test is satisfied.

Adopting a residency test for all five family-related tax benefits changes the beneficiary of certain tax benefits in certain cases. Replacing the support test with the residency test may result in the child credit or dependency exemption shifting from the provider of support (under present law) to the taxpayer who satisfies the residency test (under the proposal).[246] For example, a child who lives with his or her father, but who is provided more than one half of his or her support by the mother who lives elsewhere, no longer entitles the mother to a child credit or the dependency exemption with respect to that child.

The treatment of means-tested government benefits has policy implications under present law. Present law generally treats such benefits as provided by the government, not by the taxpayer, for purposes of determining support and the cost of maintaining a household. Some, including the IRS Taxpayer Advocate, argue that such government benefits should be disregarded for these purposes, so that a taxpayer who receives public benefits is not penalized simply because he or she receives such benefits. The treatment of public benefits for these

[246] In certain cases, the proposal may expand the child credit and dependent care benefits, such as in those cases involving no taxpayer who satisfies the support test.

purposes becomes less important to the extent that the support test is replaced by a residency test.[247]

Scope of relationship test.–One might argue that additional simplification would be achieved by using a broader definition of qualifying child than that which is proposed, namely, providing that a qualifying child includes any relative of the taxpayer who is within the applicable age limit and who satisfies the residency requirement. The need to determine whether a child bears a particular relationship to a taxpayer adds one additional rule that taxpayers must apply. In addition, such a rule may cause confusion for some taxpayers because it draws an arbitrary line based on certain familial relationships that taxpayers themselves may not draw. For example, a taxpayer may care for a minor nephew and cousin as his or her own children in his or her home. The nephew may be a qualifying child, but the cousin generally could not be, because "cousin" is not included in the specified relationships. A broader definition of qualifying child than that proposed, however, would involve a policy change with respect to some provisions. In particular, a broader definition could significantly expand the class of persons for which the earned income credit and the child credit could be claimed, which involves policy implications beyond the scope of establishing a uniform definition to be used for multiple tax benefits.

Uniform age test.–To achieve the greatest amount of simplification, a uniform age would be adopted for purposes of defining a qualifying child. The proposal adopts a uniform age test for purposes of the dependency exemption, the earned income credit, and head of household filing status, but retains the different present-law age tests for the child credit and dependent care credit.

Some argue that the dependent care credit has a different policy objective than the other provisions for which the definition of qualifying child is relevant and that this different objective warrants a different age rule. The dependent care credit provides a subsidy for individuals who incur employment-related expenses for the care of a child or certain other individuals, which expenses generally cease to be unnecessary many years before the child realizes the age of majority. In contrast, the other provisions relating to children generally have the objective of reducing tax liability for taxpayers with children, including teenage children. Because determining the age of a child generally is not difficult, some argue that a limited exception to the generally applicable age limit for the dependent care credit does not undermine the objectives of simplification. The staff of the Joint Committee on Taxation previously rejected a uniform age for purposes of all of the family-related tax benefits on the ground that a limited exception to a generally applicable age limit would not undermine the objectives of simplification, and recommended that the present-law under age 13 rule be retained for the dependent care credit.

Some argue that there does not appear to be a separate policy underlying the present-law child credit that justifies an age requirement (under age 17 whether or not disabled) that differs

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[247] The issue remains, however, to the extent that a taxpayer applies the support test instead of the residency test for the dependency exemption. Under a separate proposal of the President's budget proposal, the household maintenance test is eliminated for head of household filing status.

from that under the other family related tax benefits. The legislative history of the child credit indicates that it is intended to provide tax relief for families with children, which arguably is similar to the policy of the dependency exemption.[248] Adopting a uniform age requirement that would increase the child credit to children under 19, for example, would promote simplification, but would expand the number of children who would qualify for the child credit. The proposal retains the present-law under age 17 test for the child credit.

Waivers in cases of divorced or legally separated parents

The treatment of children of divorced or separated parents raises significant policy issues. For a number of years the Code has permitted divorced or separated parents to negotiate dependency exemptions between themselves, through a waiver of the dependency exemption by the custodial parent to the noncustodial parent, provided that together they provide over one half of the child's support and satisfy certain other requirements.[249] Many have come to view the present-law waiver rules as a bargaining chip in divorce and separation negotiations. Perhaps most important, it is oftentimes argued that the parent with the means to provide child support is much more willing to make child support payments if he or she obtains a tax benefit for doing so.

Recommendations regarding the present-law custodial waiver have ranged from repeal of the present-law provision, with no grandfather rule for existing child support instruments, to retention of a waiver rule that is amended to address significant differences in treatment of children of divorced or separated parents resulting from State court determinations. The explanation to a recent proposal made by the IRS Taxpayer Advocate stated that courts in 35 States have held that they have authority to allocate the dependency exemption between spouses who are before them in a divorce or custody case. The IRS Taxpayer Advocate made a specific recommendation that the present-law waiver rule be amended to clarify that a custodial parent must voluntarily sign a written release of the dependency exemption to the noncustodial parent, and to provide that the dependency exemption cannot be allocated (or enforced against a custodial parent involuntarily) by State domestic relations courts.[250]

The staff of the Joint Committee on Taxation concluded that the present-law custodial waiver rule primarily is designed to avoid difficult determinations under the support test, and that such waivers would not be necessary if the support test is replaced by a residency test for

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[248] A variety of proposals to provide further simplification by eliminating or reducing overlapping benefits relating to children have been proposed, including proposals that would combine the dependency exemption and the child credit. Some proposals would also combine these provisions with the earned income credit. Such proposals would provide additional simplification, but also raise additional policy issues.

[249] In 1997, the ability to negotiate tax benefits in these circumstances was extended to the child credit, which generally is available with respect to a child under age 17 if the taxpayer is entitled to the dependency exemption with respect to such child.

[250] National Taxpayer Advocate FY 2001 Annual Report to Congress, at 105 (2002).

purposes of a uniform definition of qualifying child.[251] Some have criticized proposals to repeal the custodial waiver, stating that a repeal of the waiver rules would add significantly greater complexity to divorce proceedings, and would reduce the financial flexibility (and thus increase the financial burden) of families that are parties to such proceedings.

The proposal repeals the present-law custodial waiver, but retains a grandfather rule for certain child support instruments in effect on the date proposed legislation is announced. If waiver rules are considered desirable in the case of divorce or legal separation, appropriate rules (beyond the proposed grandfather rule) could be developed.

Interaction with present-law rules and taxpayer selectivity

The proposal permits taxpayers who are eligible to claim the same individual as a qualifying child to choose which taxpayer will claim the dependency exemption with respect to the qualifying child, so long as only one taxpayer actually claims that qualifying child. Some argue that this taxpayer selectivity promotes maximum utilization of family-related tax benefits to minimize the possibility that a tax benefit will not be allocated to a taxpayer who is unable to use the benefit. Others argue that in addition to increasing complexity, such selectivity promotes gaming, and should not be permitted even if it results in no taxpayer obtaining the tax benefit.

Prior Action

A similar proposal was included in the President's fiscal year 2004 budget proposal.

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[251] 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, 56 (JCS-3-01), April 2001. Others have agreed that retention of the present-law waiver rule arguably is unnecessary, and have argued that if the waiver rule is retained, a case can be made that waiver should be extended to all taxpayers without regard to divorce or legal separation. *See e.g.*, Schenk, Deborah H., *Old Wine in Old Bottles: Simplification of Family Status Tax Issues*, presented at the NYU/Tax Analysts Government Tax Policy Workshop, Tax Code Complexity (February 9, 2001), published in Tax Notes, Vol. 91, No. 9 (May 28, 2001), 1437, 1450.

B. Repeal Phase-Out for Adoption Provisions

Present Law

Tax credit

A maximum nonrefundable credit of $10,000 per eligible child is allowed for qualified adoption expenses paid or incurred by the taxpayer. An eligible child is an individual (1) who has not attained age 18 or (2) who is physically or mentally incapable of caring for him or herself.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption are qualified adoption expenses. Generally, a taxpayer is not eligible for the adoption credit in the year that qualified adoption expenses are paid or incurred by the taxpayer, but rather, in the next taxable year. An exception is provided for qualified adoption expenses paid or incurred in the year the adoption becomes final.

In the case of a special needs child, the adoption expenses taken into account are increased by the excess, if any, of $10,000 over actual qualified adoption expenses otherwise taken into account for that special needs child. A special needs child is an eligible child who also meets other requirements. Specifically, a special needs child must be a citizen or resident of the United States which the State has determined: (1) cannot or should not be returned to the home of the birth parents, and (2) has a specific factor or condition because of which the child cannot be placed with adoptive parents without adoption assistance.

Exclusion from income

Present law provides a maximum $10,000 exclusion from the gross income of an employee for qualified adoption expenses (as defined above) paid by the employer. The $10,000 limit is a per-child limit, not an annual limitation. In the case of a special needs adoption, the amount of adoption expenses taken into account in determining the exclusion for employer-provided adoption assistance is increased by the excess, if any, of $10,000 over the amount of the aggregate adoption expenses otherwise taken into account for that special needs child.

Description of Proposal

The proposal repeals the income phase-outs of the adoption credit and the exclusion for qualified adoption expenses.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Repeal of the phase-outs of the adoption credit and of the exclusion of adoption assistance simplifies the tax system for those claiming the credit or exclusion. Removing the

phase-outs reduces the uncertainty as to whether a taxpayer is eligible for the credit or exclusion, and simplifies preparation of tax returns for those who adopt children. Additionally, for taxpayers beyond the phase-out range (no credit or exclusion allowed) or in the phase-out range (credit or exclusion limited), the repeal of the phase-outs creates, or increases, a financial incentive to adopt children. Opponents of repeal may argue that it is appropriate to restrict the benefits of the credit or exclusion such that the highest income taxpayers, who can afford to adopt without additional assistance, do not receive a tax reduction as a result of adopting children.[252]

Prior Action

A similar proposal was included in the President's fiscal year 2004 budget proposal.

[252] For a complete discussion of policy issues with regard to the elimination of phase-outs, 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, 79-91 (JCS-3-01), April 2001. This study includes recommendations to repeal many phase-outs, including the phaseout relating to the adoption credit and exclusion.

C. Eliminate Household Maintenance Test for Head-of-Household Filing Status

Present Law

Head of household filing status[253]

There are four different filing statuses for individuals who file Federal income tax returns: single, married filing separately, married filing jointly, and head of household. A taxpayer filing as a head of household is able to claim a larger basic standard deduction than a taxpayer who files as single or as married filing separately. For example, the basic standard deduction for calendar year 2004 for head of household filing status is $7,150, compared to $4,850 for taxpayers who file as single or as married filing separately. In addition, head of household filing status provides a taxpayer with more favorable rate brackets than if the taxpayer filed as single or as married filing separately.

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half of the year of (1) an unmarried son, daughter, stepson or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son or daughter, (2) an individual described in (1) who is married, if the taxpayer may claim a dependency exemption with respect to the individual (or could claim the exemption if the taxpayer had not waived the exemption to the noncustodial parent), or (3) a relative with respect to whom the taxpayer may claim a dependency exemption.[254] If certain other requirements are satisfied, head of household filing status also may be claimed if the taxpayer is entitled to a dependency exemption with respect to one of the taxpayer's parents.

Surviving spouse rules

A taxpayer who qualifies as a surviving spouse may use the basic standard deduction and rate brackets that are applicable to married taxpayers filing jointly. A taxpayer may qualify as a surviving spouse if his or her spouse died during either of the two years immediately preceding the current taxable year, and the taxpayer maintains as his or her home the household that constitutes for the taxable year the principal place of abode for a dependent who is the taxpayer's son, daughter, or stepchild. For this purpose, an individual is considered as maintaining a household only if the individual furnishes over half the cost of maintaining the household during the taxable year.

Description of Proposal

The proposal eliminates the requirement that the taxpayer pay more than half the cost of maintaining the household in order to claim head of household filing status. An unmarried

[253] Sec. 2(b).

[254] Sec. 2(b)(1)(A)(ii), as qualified by sec. 2(b)(3)(B). An individual for whom the taxpayer is entitled to claim a dependency exemption by reason of a multiple support agreement does not qualify the taxpayer for head of household filing status.

taxpayer generally may file as head of household if: (1) he or she resides with a qualifying child, or a related dependent, for more than half the taxable year; or (2) he or she claims a parent as a dependent, regardless of whether the parent resides with the taxpayer. A special rule applies in the case of unmarried parents who reside together with their son or daughter for more than half the year. In such cases, only one of the parents may claim head of household filing status with respect to the son or daughter. If both parents claim head of household filing status with respect to the son or daughter, only the parent with the higher adjusted gross income could claim the son or daughter. If the unmarried parents reside together with more than one son or daughter, the special rule applies (that is, only one of the two parents may claim head of household filing status).

The proposal also eliminates the household maintenance test for purposes of the surviving spouse rules. Under the proposal, a taxpayer is considered a surviving spouse if his or her spouse died during either of the two years immediately preceding the current taxable year, and the taxpayer resides with his or her dependent child (son, daughter or stepchild) for over half the taxable year.

The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

The proposal would simplify tax administration by permitting an unmarried taxpayer to claim a filing status that is more advantageous than single without having to determine whether the taxpayer provided over half the cost of certain expenses for the qualifying child or other dependent. Instead, the taxpayer need only show that the qualifying child or other dependent resided with the taxpayer in the same principal place of abode for more than half the taxable year. Eliminating the expense test is consistent with other simplification proposals that eliminate the support test and replace it with the requirement that the child or other dependent satisfy a residency test with respect to the taxpayer.

Some may argue that the proposal has the effect of eliminating the head of household filing status and replacing it with a filing status for unmarried taxpayers with a qualifying child or other dependent who resides with the taxpayer.

The staff of the Joint Committee on Taxation simplification proposal to adopt a uniform definition of qualifying child recommended that the household maintenance test be retained for purposes of head of household filing status.[255] The staff noted that eliminating the test might decrease complexity, but stated that the test is integral to head of household filing status.

Prior Action

No prior action.

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[255] 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, 58 (JCS-3-01), April 2001.

D. Reduce Computational Complexity of Refundable Child Tax Credit

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000 in 2004, $700 in 2005, 2006, 2007, and 2008, $800 in 2009, and $1,000 in 2010. A child who is not a citizen, national, or resident of the United States may not be a qualifying child.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 10 percent of earned income in excess of $10,750 (the "earned income" formula). The percentage is increased to 15 percent for calendar years beginning after 2004. The threshold dollar amount is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit ("EIC").

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EITC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Residents of U.S. possessions (e.g., Puerto Rico) are generally not eligible for the refundable child credit, because the earned income formula is based on earned income to the extent the earned income is included in taxable income. Because residents of possessions are not subject to the U.S. income tax on income earned outside the U.S., they are not generally eligible for the refundable child credit. However, the alternative child credit formula for taxpayers with three or more children is based on social security taxes, and thus residents of possessions with three or more children are eligible for the refundable child credit if they pay social security taxes, as do Puerto Ricans on Puerto Rican or U.S. sourced earnings.

Description of Proposal

The proposal repeals the alternative formula based on the excess of the social security taxes paid over the amount of the EIC. Thus, the additional child tax credit will be based solely on the earned income formula, regardless of the number of children in a taxpayer's family.

Also, the proposal eliminates the requirement that earned income be included in taxable income for purposes of computing the additional child tax credit. This conforms the definition of earned income for purposes of the refundable child credit and the EIC (i.e., earned income for both credits equals the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings). Thus, net self-employment earnings that are not included in taxable income will be included in earned income for purposes the additional child credit.

Finally, the proposal requires taxpayers to reside with a child in the United States to claim the additional child tax credit. For these purposes, the principal place of abode for members of the U.S. Armed Forces is treated as in the United States for any period the member is stationed outside the United States while serving on extended active duty. Extended active duty includes a call or order to such duty for a period in excess of 90 days.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

A single rule for calculating the refundable child credit will provide simplification for taxpayers with three or more children who otherwise must make two separate calculations: the earned income formula and the alternative formula. The vast majority of such taxpayers find that the alternative formula calculation does not yield a higher credit amount so its repeal would make the credit calculation simpler without changing total benefits. While the vast majority of taxpayers benefit from the simplification of this change, taxpayers for whom the alternative formula produces the greater benefit would receive a smaller refundable child credit than that provided by current law. In general, taxpayers who find the alternative formula more valuable are: (1) residents of Puerto Rico, who do not pay U.S. income taxes and are not eligible to claim the EIC, but who may nonetheless may file a U.S. income tax return to claim a refundable child credit, and (2) taxpayers in the United States who are eligible for the child credit but not eligible to claim the EIC.

Use of the same measure of earned income for both the refundable child credit and the EIC will provide simplification for all taxpayers claiming both credits. While for virtually all taxpayers the two measures of income yield the same result under present law, the fact that this is not true of all taxpayers requires additional instructions for all. Taxpayers for whom the two measures of earned income differ are those who have certain self-employment earnings, such as a parsonage allowance, that is excluded from gross income for individual income tax purposes. The President's proposal to adopt the EIC definition of earned income for purposes of the refundable child credit (that is, to eliminate the requirement that the earned income be included in taxable income) will expand the availability of the refundable child credit to income not subject to the individual income tax, which some might view as an undesirable policy result.

The modified definition would allow Puerto Ricans with fewer than three children to claim the refundable child credit but for the President's proposal that eligibility for the refundable credit be conditioned on United States residency (discussed below).

An alternative proposal that only modifies the EIC earned income definition by requiring that self-employment income be included in gross income (as is required for non self-employment income) would appear to achieve similar simplification without affecting the child credit for residents of Puerto Rico with children. The alternative proposal would result in the same definition of earned income for purposes of the EIC and refundable child credit for all persons with self-employment earnings regardless of whether any self-employment earnings is excluded from gross income for income tax purposes (such as is the case for parsons with parsonage allowances). Additionally, the proposal would treat employees and the self-employed equivalently in determining both the EIC and refundable child credit.

The President's proposal requires taxpayers to reside in the United States in order to claim the refundable child credit. The principal effect of this proposal is to prevent the expansion of the refundable child credit to residents of Puerto Rico with fewer than three children that would occur under the President's proposal to conform the earned income definition for purposes of the EIC and the refundable child credit. There does not appear to be any particular simplification that results from the proposal other than to prevent Puerto Ricans, who are not required to file a U.S. income tax return, from filing such a return for the sole purpose of claiming a refundable credit.

The President's proposal to require U.S. residency in order to claim a refundable child credit would deny the refundable child tax credit to certain taxpayers living abroad who may currently claim it. In some cases this may not be considered desirable, such as in the case of a low-income U.S. citizen who works in the U.S. but who happens to live in Canada or Mexico. In other cases the result may be viewed as desirable. For example, a married U.S. taxpayer with two children who lives and works in a foreign country with $100,000 foreign earned income would have a gross income of only $20,000 as a result of the $80,000 foreign earned income (section 911) exclusion. As a result of other provisions of U.S. law such as the personal exemptions and child credits, such a taxpayer would have no U.S. income tax liability. However, because the refundable child credit is based on only earned income included in taxable income, the taxpayer is eligible for a refundable credit of 10 percent of the amount by which such income (in this case $20,000) exceeds $10,750, or $9,250, for a refundable credit of $925. Under present law, and under the proposal, the taxpayer is not eligible for the EIC. The policy for paying a refundable child credit in such a case is questionable, especially considering the refundable credit is only payable once the taxpayer's earned income reaches $90,750 ($80,000 section 911 exclusion plus refundable child credit earned income threshold of $10,750).

<u>Prior Action</u>

No prior action.

E. Simplify EIC Eligibility Requirements Regarding Filing Status, Presence of Children, Investment Income and Work and Immigrant Status

Present Law

Overview

Low and moderate-income workers may be eligible for the refundable earned income credit (EIC). Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The earned income credit generally equals a specified percentage of wages up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI)), if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,650 (for 2004). This threshold is indexed. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year shall not be considered as married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year,[256] and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

[256] A foster child must reside with the taxpayer for the entire taxable year.

Presence of qualifying children and amount of the earned income credit

The EIC is available to low and moderate-income working taxpayers. Three separate schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, and one schedule for taxpayers with more than one qualifying child.[257]

Taxpayers with one qualifying child may claim a credit in 2004 of 34 percent of their earnings up to $7,660, resulting in a maximum credit of $2,604. The maximum credit is available for those with earnings between $7,660 and $14,040 ($15,040 if married filing jointly). The credit begins to phase down at a rate of 15.98 percent of earnings above $14,040 ($15,040 if married filing jointly). The credit is phased down to 0 at $30,338 of earnings ($31,338 if married filing jointly).

Taxpayers with more than one qualifying child may claim a credit in 2004 of 40 percent of earnings up to $10,750, resulting in a maximum credit of $4,300. The maximum credit is available for those with earnings between $10,750 and $14,040 ($15,040 if married filing jointly). The credit begins to phase down at a rate of 21.06 percent of earnings above $14,040 ($15,040 if married filing jointly). The credit is phased down to $0 at $34,458 of earnings ($35,458 if married filing jointly).

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $5,100, resulting in a maximum credit of $390, for 2004. The maximum is available for those with incomes between $5,100 and $6,390 ($7,390 if married filing jointly). The credit begins to phase down at a rate of 7.65 percent of earnings above $6,390 ($7,390 if married filing jointly) resulting in a $0 credit at $11,490 of earnings ($12,490 if married filing jointly).

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EIC. If multiple eligible taxpayers actually claim the same qualifying child, then a tiebreaker rule determines which taxpayer is entitled to the EIC with respect to the qualifying child. The eligible taxpayer who does not claim the EIC with respect to the qualifying child may not claim the EIC for taxpayers without qualifying children.

Definition of qualifying child

In order to be a qualifying child, an individual must satisfy a relationship test, a residency test, and an age test. The relationship test requires that the individual be (1) a child, stepchild, a descendant of a child or stepchild, or a foster or adopted child of the taxpayer, or (2) a sibling, stepsibling, or descendent of a sibling of stepsibling. The residency test requires that the individual have the same place of abode as the taxpayer for more than half the taxable year. The

[257] All income thresholds are indexed for inflation annually.

household must be located in the United States. The age test requires that the individual be under 19 (24 for a full time student) or be permanently and totally disabled.[258]

Taxpayer identification number requirements

Individuals are ineligible for the credit if they do not include their taxpayer identification number (TIN) and their qualifying child's TIN (and, if married, their spouse's TIN) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a TIN is defined as a Social Security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act regarding the issuance of a number to an individual applying for or receiving federally funded benefits. If an individual fails to provide a correct taxpayer identification number, such omission will be treated as a mathematical or clerical error by the IRS.

A taxpayer who resides with a qualifying child may not claim the EIC with respect to the qualifying child if such child does not have a valid TIN. The taxpayer also is ineligible for the EIC for workers without children because he or she resides with a qualifying child.

Description of Proposal

Overview

The proposal modifies present law EIC rules by (1) altering the rules with respect to EIC claims made by separated spouses;[259] (2) simplifying the rules regarding claiming the EIC for workers without children; (3) eliminating the disqualified investment income test; and (4) changing the taxpayer identification number requirements for taxpayers and their qualifying children with respect to the EIC.

Claims by separated spouses

The proposal modifies present law regarding EIC claims made by separated spouses. Under the proposal, a married taxpayer who files a separate return (as married filing separately) is allowed to claim the EIC if he or she lives with a qualifying child for over half the year, provided the taxpayer lives apart from his or her spouse for the last six months of the taxable year and otherwise satisfies the generally applicable EIC provisions.[260] Under the proposal, a married taxpayer who satisfies these requirements, and files as married filing separately, is not

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[258] The IRS has issued guidance stating that for purposes of the earned income credit, an individual attains a specified age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004). Rev. Rul. 2003-72, 2003-33 I.R.B. 346.

[259] Secs. 32(d) and 7703(b).

[260] The proposal adopts the qualifying child test for this purpose, rather than the "dependent child" test that applies under present law.

required to provide over half the cost of maintaining the household in which the qualifying child resides.

Claims for EIC for workers without children

The proposal modifies the rules for EIC claims made by multiple taxpayers residing in the same principal place of abode in which a qualifying child resides. Under the proposal, if multiple taxpayers residing in the same principal place of abode are eligible to claim the same qualifying child, an otherwise eligible taxpayer may claim the EIC for workers without children (maximum credit of $390 for 2004) even if another taxpayer within the same principal place of abode claims the EIC with respect to the qualifying child. However, if unmarried parents reside together with their child or children (sons, daughters, stepchildren, adopted children, or foster children), then one parent may claim the EIC for taxpayers with qualifying children, but neither parent may claim the EIC for workers without children.[261]

Eliminating the disqualified investment income test

The proposal eliminates the disqualified investment income test. Under the proposal, a taxpayer who otherwise qualifies for the EIC is not disqualified for having investment income of any type or amount.

TIN requirements

The proposal provides that both the taxpayer (including his or her spouse, if married) and the qualifying child must have a social security number that is valid for employment in the United States (that is, the taxpayer and qualifying child must be United States citizens, permanent residents, or have certain types of temporary visas that allow them to work in the United States). Under the proposal, taxpayers who receive social security numbers for non-work reasons, such as for purposes of receiving Federal benefits or for any other reason, are not eligible for the EIC.

The proposal also provides that if a qualifying child does not have a valid TIN, a taxpayer is eligible to claim the EIC for workers without children (maximum credit of $390 for 2004). If a taxpayer has two or more qualifying children, some of whom do not have a valid TIN, the taxpayer may claim the EIC based on the number of qualifying children for whom there are valid TINs.

Effective date

The proposal generally is effective for taxable years beginning after December 31, 2004. The clarification that taxpayers and qualifying children must have social security numbers that are valid for employment is effective for taxable years beginning after December 31, 2003.

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[261] Both under the proposal and present law, unmarried parents who reside together with multiple qualifying children who are their sons, daughters, stepchildren, adopted children, or foster children, may allocate the qualifying children between them for earned income credit purposes.

Analysis

Claims by separated spouses

The proposal eliminates the household maintenance test for a separated spouse who claims the EIC. Married taxpayers filing separate returns who reside with qualifying children may claim the EIC if they live apart from their spouse for the last half of the year. As under present law, such a taxpayer could not file as a head of household unless he or she also satisfies a household maintenance test and resides with a dependent child. This proposal simplifies the determination of whether a separated spouse is eligible to claim the earned income credit, and increases the number of separated spouses living with a qualifying child who could claim the EIC for taxpayers with qualifying children.

The proposal also expands the relationship component of the separated spouse test for purposes of the EIC. Under present law, an otherwise eligible separated spouse only may file as head of household for purposes of claiming the EIC (and not have to file married filing jointly) if the separated spouse shares a principal place of abode with a son, daughter, or stepchild. Under the proposal, an otherwise eligible separated spouse may claim the EIC (and not have to file married filing jointly) if the separated spouse files as married filing separately and shares a principal place of abode with a son, daughter, stepchild, adopted son, foster child, or any other individual who constitutes a qualifying child under the proposed uniform definition of qualifying child.[262] This increases the number of separated spouses living with a child who could claim the EIC for taxpayers with qualifying children.

Claims for EIC for workers without children

Some may argue that the proposal to permit a taxpayer to claim the EIC for taxpayers without qualifying children (maximum of $390 for 2004) in cases where the taxpayer has a qualifying child, but another taxpayer claims the qualifying child for EIC purposes, has the potential to add administrative complexity for both taxpayers and the IRS. Under the proposal, each eligible taxpayer has an incentive to calculate his or her taxes under two alternatives to determine the maximum aggregate EIC available to the multiple taxpayers who could claim the qualifying child: one alternative in which the taxpayer claims the qualifying child for the EIC (and the other taxpayer claims the EIC for taxpayers without qualifying children), and one in which the taxpayer claims the EIC without the qualifying child (and the other taxpayer claims the EIC for taxpayers with a qualifying child). Presumably the taxpayers would wish to select that filing combination that yields the lowest tax cost, or the highest tax benefit, to the parties. The proposal provides flexibility to taxpayers so that they are able to allocate the qualifying child to a taxpayer in a manner that maximizes the aggregate earned income credit, and may increase the aggregate credit paid when compared to present law, but might do so at the cost of increasing the complexity of the tax system. Others may argue that the proposal does not increase selectivity or materially increase complexity, because multiple taxpayers who are eligible to claim the same qualifying child for the EIC currently have an incentive to calculate their taxes

[262] A separate proposal of the President's budget proposal establishes a uniform definition of qualifying child for EIC and other family-related tax benefits.

under two alternatives (each computes the EIC for qualifying children, but not the EIC for taxpayers without qualifying children) to yield the lowest tax cost or the highest tax benefit for the parties.

The proposal's adoption of different rules for unmarried parents than for other taxpayers who reside with a qualifying child in the same residence creates complexity, and places unmarried parents at a disadvantage when compared with other types of extended family situations (e.g., a mother and grandmother sharing the same principal place of abode with a qualifying child).

Elimination of disqualified investment income test

Under present law, a taxpayer who otherwise is eligible for the earned income credit (including the maximum credit amount) loses the entire credit if he or she has investment income that exceeds the investment income limit. For example, under present law, a taxpayer with $2,650 of investment income in 2004 who is eligible for the maximum credit of $4,300, would lose the entire credit if he or she had an additional dollar of investment income. Eliminating the disqualified investment income test eliminates the cliff effect that can deny an EIC to a taxpayer merely because he or she has an additional dollar of investment income. However, the cliff effect could be addressed by implementing a phaseout rule so that the credit is reduced as investment income exceeds certain amounts. Adopting a phaseout rule for disqualified investment income would also increase complexity. Eliminating the investment income test also could result in some wealthy taxpayers with relatively modest earned income amounts receiving an earned income credit, for example, if they have net operating losses that offset their investment income and other types of income, such that their adjusted gross income is within the EIC phaseout ranges. To prevent wealthy taxpayers from being eligible for the earned income credit, the investment income ceiling could be increased, rather than eliminated.

TIN requirements

The proposal permits a taxpayer to claim the EIC for taxpayers without a qualifying child (maximum credit of $390 for 2004) if the taxpayer has a qualifying child who does not have a valid TIN. The proposal has the effect of reducing the amount of the lost tax benefit associated with failing to satisfy the TIN requirement for a qualifying child. Some may argue that this is equitable because it treats a taxpayer with a qualifying child who lacks a valid TIN in the same manner as a taxpayer who does not have a qualifying child. Others may argue that in some cases the proposal reduces the incentive for a taxpayer to obtain a valid TIN for a qualifying child.

Prior Action

No prior action.

F. Simplify the Taxation of Dependents

Present Law

Filing requirements for children

A single unmarried individual eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has: (1) earned income only over $4,850 (for 2004); (2) unearned income only over the minimum standard deduction amount for dependents ($800 in 2004); or (3) both earned income and unearned income totaling more than the smaller of (a) $4,850 (for 2004) or (b) the larger of (i) $800 (for 2004), or (ii) earned income plus $250.[263] Thus, if a dependent child has less than $800 in gross income, the child does not have to file an individual income tax return for 2004.

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income under section 1(g)

Special rules apply to the unearned income of a child under age 14. These rules, generally referred to as the "kiddie tax," tax certain unearned income of a child at the parent's rate, regardless of whether the child can be claimed as a dependent on the parent's return.[264] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year; (2) the child's investment income was more than $1,600 (for 2004); and (3) the child is required to file a return for the year. The kiddie tax applies regardless of the source of the property generating the income or when the property giving rise to the income was transferred to or otherwise acquired by the child. Thus, for example, the kiddie tax may apply to income from property acquired by the child with compensation derived from the child's personal services or from property given to the child by someone other than the child's parent.

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($800 for 2004), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized

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[263] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 3, Table 1 (2003).

[264] Sec. 1(g).

deductions that are directly connected with the production of the unearned income.[265] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase.

If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.[266]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return. In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax or;

(2) the tax on the child's income without regard to the kiddie tax provisions.

Parental election to include child's unearned income

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The requirements for the election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[267]

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[265] Sec. 1(g)(4).

[266] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 6 (2003).

[267] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2003).

(2) such income is more than the minimum standard deduction amount for dependents ($800 in 2004) and less than 10 times that amount;

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child’s gross income in excess of $1,600 for 2004). This amount is taxed at the parent’s rate. The parent also must report an additional tax liability equal to the lesser of: (1) $80 (in 2004), or (2) 10 percent of the child’s gross income exceeding the child’s standard deduction ($800 in 2004).

Including the child’s income on the parent’s return can affect the parent’s deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[268] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[269] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[270]

Taxation of compensation for services under section 1(g)

Compensation for a child’s services is considered the gross income of the child, not the parent, even if the compensation is not received or retained by the child (e.g. is the parent’s income under local law).[271] If the child’s income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child’s services.[272]

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[268] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2003).

[269] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2003).

[270] Sec. 1(g)(7)(B).

[271] Sec. 73(a).

[272] Sec. 6201(c).

Description of Proposal

The proposal modifies the standard deduction for all dependents. Under the proposal, the standard deduction for a taxpayer who is a dependent of another taxpayer is $800 (indexed for inflation) plus the amount of the dependent's earned income, but not to exceed the standard deduction for a single filer who is not a dependent of another taxpayer.

The proposal also modifies the present law rules regarding the kiddie tax for children under age 14. Under the proposal, a child under age 14 would be required to file his or her own tax return if his or her income exceeded the standard deduction amount. The election to include the child's investment income on the parent's tax return is eliminated.

The income of a child under age 14 is subject to special tax rates. For such children, all earned income, and the first $2,500 (indexed after 2005) of taxable investment income, is taxed at the child's own tax rates. Any taxable investment income (other than dividends or capital gains) above the indexed $2,500 amount generally is taxed at the highest regular income tax rate, regardless of the child's or the parent's tax rates. Any dividends or capital gains included in the child's taxable investment income above the indexed $2,500 amount, however, are taxed at the highest dividends or capital gains tax rates, respectively, generally applicable for the taxable year.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

The "kiddie tax" was enacted to restrict the practice of high-income individuals transferring income-producing property to their children so that the income would be taxed at lower rates.

The proposal eliminates the parental election to report the income of a child under age 14 on the parent's tax return. Under the proposal, every child who exceeds the applicable income requirements, regardless of age, is required to file his or her own separate return. This may increase the number of returns that a family with children is required to file. It also prevents a parent from being able to report the income of several children on the parent's return.

Under the proposal, a child's income would no longer be taxed by reference to the tax rate of his or her parents. Instead, the child's income would be taxed at the child's own rates, or in some cases, at the highest individual income tax rates. This may result in the child's income being taxed at higher or lower rates than is the case under present law, depending upon the respective rates of the child and the parent and the highest individual income tax rates. By removing the linkage between the child's return and the parent's return, however, information regarding the parent's income would not be needed to complete the child's return.[273] This may

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[273] Under present law, information regarding a sibling's return also is needed if a parent has more than one child subject to the kiddie tax. In such cases, the net unearned income of all children is combined, a single kiddie tax is calculated, and each child is allocated a proportionate share of the allocable parent tax.

reduce complexity and make it easier for some taxpayers to file tax returns without having to obtain information from other taxpayers.

The Administration proposal would increase the filing threshold for a number of taxpayers, thereby simplifying tax administration through the elimination of numerous return filings. The proposal would decrease, however, the amount of income subject to income tax.

The staff of the Joint Committee on Taxation recommended modifications to the kiddie tax.[274] The Joint Committee staff proposal would apply the tax rate schedule applicable to trusts to net unearned income of a child under age 14. The use of trust rates may result in the imposition of greater taxes than under present law, although it also would remove the linkage between the child's return and the parent's return. Also, the staff's proposal would expand the parental election to include the child's income on the parent's return to all types and amounts of the child's income, without regard to whether there was withholding or estimated tax payments with respect to the child's income. This would reduce the number of returns required to be filed with respect to the income of children under age 14.

Some believe that the rationale for applying the kiddie tax rules to children under 14 also applies to older children who have not yet attained the age of majority, and that the present-law rules (or the proposed rules) should be extended to those under 18.

Prior Action

No prior action.

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[274] 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, 144-49 (JCS-3-01), April 2001.

G. Education Proposals

1. Consolidate higher education credits and deductions

Present Law

A taxpayer may deduct up to $4,000 of qualifying higher education expenses. Single taxpayers whose modified AGI does not exceed $65,000 ($130,000 for married taxpayers filing joint returns) may deduct up to $4,000 of qualified expenses. Taxpayers with modified AGI between $65,000 and $80,000 (between $130,000 and $160,000 for married taxpayers filing joint returns) may deduct up to $2,000 of qualified expenses. This deduction is an above-the-line deduction, meaning it is available even if the taxpayer does not itemize deductions. This provision was enacted on a temporary basis in 2001 and expires after 2005.

A taxpayer may claim one or both of the Hope and lifetime learning credits for qualified tuition and fees for enrollment of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent in a postsecondary degree or certificate program. To be eligible for the Hope credit, the student must be enrolled on at least a half-time basis. The Hope Credit is equal to 100 percent of the first $1,000 of qualified expenses and 50 percent of the next $1,000 of qualified expenses, for a maximum credit of $1,500 per student. The Hope Credit is only available for the first two years of a student's postsecondary education.

A taxpayer may claim a nonrefundable lifetime learning credit for all postsecondary education, including graduate education and programs not leading to a degree or certificate. The credit is equal to 20 percent of up to $10,000 of qualified tuition and required fees paid during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. There is no limit on the number of years for which the lifetime learning credit may be claimed. The $10,000 amount is not indexed for inflation.

With respect to the same student, a taxpayer must choose between the lifetime learning credit, the deduction for higher education expenses, and the Hope credit (if the student is in the first two years of post-secondary education).

For calendar year 2004, the Hope credit and the lifetime learning credit are phased out over the modified AGI range of $42,000 to $52,000 ($85,000 to $105,000 for married taxpayers filing joint returns). The length of the phaseout range is fixed at $10,000 ($20,000 for married taxpayers filing joint returns) but the beginning of the range is indexed for inflation subject to a $1,000 rounding convention. In addition, the amount of the allowable Hope credit is indexed for inflation in future years (subject to a $100 rounding convention). Taxpayers may claim the Hope credit for more than one qualifying student. In contrast, the lifetime learning credit is applied on a per-taxpayer, rather than a per-student, basis.

A taxpayer may deduct up to $2,500 of interest on student loans. This deduction is phased out between $50,000 and $65,000 of modified adjusted gross income ("AGI") for single taxpayers($100,000 and $130,000 for married taxpayers filing joint returns). The phase-out thresholds are indexed for inflation subject to a $5,000 rounding convention. The deduction is available regardless of whether the taxpayer claims any of the other tax benefits related to education.

Description of Proposal

Under the Administration's proposal, the lifetime learning credit is revised to subsume the deductions for student loan interest and qualified higher education expenses by allowing the credit on a per-student basis and treating up to $2,500 of interest on student loans as a qualified expense. The temporary above-the-line deduction for higher education expenses and the deduction for student loan interest is repealed. The beginning of the phase-out range is raised to $50,000 of modified AGI($100,000 for joint returns) and a new phase-out rule is added that would reduce the otherwise allowed credits by 5 percent of the extent to which modified AGI exceeds the new limits. The phase-out rules for the Hope credit is conformed to those of the revised lifetime learning credit.

The dollar limits of the revised lifetime learning credit and the Hope credit are indexed for inflation after 2005 using a $100 rounding convention. The phase-out rules for the Hope credit and the lifetime learning credit are indexed for inflation after 2005 using a $1,000 rounding convention.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

By eliminating the deduction for higher education expenses, the proposal provides simplification for taxpayers who, with respect to the same student, face the choice of claiming the deduction or either the Hope or lifetime learning credit. Such taxpayers may have had to make several calculations to see which tax benefit was most advantageous. If the taxpayer may claim either the Hope or the lifetime learning credit with respect to the same student, the proposal still requires calculating the benefit for each to see which results in the higher credit.[275] Such a calculation would be relatively easy in this case, however, given the credit formulas. For expenses below a certain level, the Hope credit would always yield the higher benefit, and for expenses above that level, the lifetime learning credit would be greater. IRS guidance could identify this level of expenses such that taxpayers would not have to calculate each credit themselves to see which is higher.

Subsuming the student loan interest deduction into the lifetime learning credit provides modest simplification for taxpayers who claim the student loan interest deduction in addition to claiming the lifetime learning credit or the deduction for higher education expenses. The simplification results from conforming the phaseout ranges among these provisions, rather than

[275] The staff of the Joint Committee on Taxation, in its statutorily mandated simplification study, recommended consolidating the Hope and lifetime learning credits. The deduction for higher education expenses did not exist at the time of the Joint Committee study. 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, volume ii, at 126-130.

from subsuming the deduction into the lifetime learning credit per se. As a result, only one worksheet is necessary to determine the impact of the phaseout.

The proposal substantially expands the amount of the lifetime learning credit available by making it apply on a per-taxpayer basis rather than a per-tax return basis. Additionally, both the lifetime learning credit and the Hope credit are made available to more taxpayers by the increased starting point of the phaseout and by the generally slower phaseout that results from the change in the phaseout from one that phases out all of the credit over a fixed dollar income range to the proposed phaseout that reduces the credit by an amount equal to five percent of the extent to which AGI exceeds a threshold level.

The change to the student loan interest deduction will benefit certain taxpayers and harm others. Taxpayers with marginal tax rates below the 20-percent credit rate will generally be better off under the proposal, while those with marginal tax rates above 20 percent will be worse off. Some taxpayers would find the full value of the interest deduction eliminated by the proposed treatment under the lifetime learning credit. For example, a taxpayer who claims $10,000 of education expenses under the lifetime learning credit with respect to a dependent child in his senior year of college might also incur interest expense with respect to funds borrowed to pay for earlier years of college, and such taxpayer would get no value from treating such interest expenses as eligible expenses under the lifetime learning credit since they already had education expenses equal to the maximum allowed under the lifetime learning credit. Additionally, although the phaseout of the present-law student loan interest deduction and the proposed credit begin at the same point, the phaseout of the maximum $2,500 interest expense deduction is more favorable (i.e., occurs more slowly) than the phaseout of the maximum $500 credit that would result from $2,500 of interest expense. Some taxpayers eligible for a partial interest deduction would be completely phased out of any credit.

Many taxpayers taking the deduction for higher education expenses would find that they receive little or no lifetime learning credit under the proposal. The reason for this is that eligibility for the deduction generally extends further up the income distribution than does eligibility for the proposed lifetime learning credit. For example, a family with $120,000 modified AGI and $5,000 of deductible higher education expenses is able to deduct $4,000 of such expenses under present law. If such family is in the 25-percent marginal rate bracket, the deduction is worth $1,000. Under the proposal, the potential lifetime learning credit for such expenses would be 20 percent of $5,000, or $1,000. However, since the phaseout of the credit begins at $100,000 of modified AGI and reduces the credit amount by 5 percent of the amount by which modified AGI exceeds $100,000, the $1,000 credit would be fully phased out at an income of $120,000.

Prior Action

No prior action.

2. Simplify the definitions of a qualifying higher educational institution and qualified higher education expenses

Present Law

Present law contains a number of tax benefits for higher education expenses or with respect to students at institutions of higher education. These include the provisions relating to the:

(1) Hope credit;

(2) lifetime learning credit;

(3) exclusion from income for distributions from Coverdell education savings accounts;

(4) exclusion from income for distributions from qualified tuition programs;

(5) exclusion from gross income for interest on savings bonds;

(6) above-the-line deduction for interest on educational loans;

(7) temporary above-the-line deduction for higher education expenses;

(8) exclusion from gross income for scholarships and fellowships;

(9) exclusion from gross income for qualified tuition reductions;

(10) exclusion from gift tax for amounts paid as tuition to an educational institution, and

(11) personal exemption for dependent children who are full time students and age 19 through 23.

These provisions generally require that the relevant individual be a student at an education institution. However, there is not a consistent definition of an eligible education institution. Similarly, the provisions providing tax benefits for higher education expenses contain varying definitions of qualifying expenses. The group of individuals that may benefit also differs in some cases. For example, in some cases the student must be a full-time student and there is not a consistent definition of how the student must be related to the taxpayer.

With respect to the definition of an education institution, seven of the above-listed 11 provisions define a qualifying higher education institution to mean institutions eligible to participate in Federal student aid programs under Title IV of the Higher Education Act of 1965.[276] Such institutions generally are accredited post-secondary educational institutions

[276] Provisions that use this definition are the: (1) Hope credit; (2) Lifetime learning credit; (3) exclusion from gross income for distributions from Coverdell education savings

offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The remaining four provisions define a qualifying higher education institution by reference to section 170(b)(1)(A)(ii), which includes an organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

Certain provisions also have variations on these basic definitions. For example, the above-the-line deduction for student loan expenses generally uses the definition from the Higher Education Act, but also includes institutions conducting an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility which offers postgraduate training.[277]

With respect to qualifying education expenses, there is various treatment of the following components of education expenses: (1) tuition; (2) required fees; (3) books, supplies, and equipment; (4) room and board; and (5) special needs services. The treatment of these expenses under each of the tax benefits for educational expenses is shown in Table 8.

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accounts; (4) exclusion from income for distributions from qualified tuition plan; (5) exclusion from income for interest on savings bonds; (6) above-the-line deduction for interest on education loans; and (7) the temporary above-the-line deduction for higher education expenses.

[277] Sec. 221(e)(2).

Table 8.–Treatment of Expenses Under Education Tax Benefits

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
1. Hope Credit (sec. 25A)	Included, except that tuition is a qualified expense with respect to any course or other education involving sports, games, or hobbies, only if such course or other education is part of the individual's degree program.	Included, except that (1) required fees with respect to any course or other education involving sports, games, or hobbies is included only if such course or other education is part of the individual's degree program; and (2) nonacademic fees are not included.	Not included.	Not included.	Not included.
2. Lifetime Learning Credit (sec. 25A)	Same as Hope credit.	Same as Hope credit.	Not included.	Not included.	Not included.
3. Exclusion for distributions from qualified tuition plans (sec. 529)	Included.	Included.	Included, if required for enrollment or attendance.	Included in the case of students enrolled on at least a half-time basis. Amount of room and board expenses taken into account may not exceed the greater of: (1) the room and board amount included in the institution's cost of attendance for Federal student aid purposes, or (2) the actual invoiced amount for students residing in housing owned and operation by the institution.	Included for special needs beneficiaries.[1]

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
4. Exclusion for distributions from Coverdell education savings accounts (sec. 530)	Included.	Included.	Same as qualified tuition plans.	Same as qualified tuition plans.	Same as qualified tuition plans.
5. Savings bond interest exclusion (sec. 135)	Same as Hope credit.	Same as Hope credit, except that that nonacademic fees are not excluded from the definition of fees.	Not included.	Not included.	Not included.
6. Above-the-line deduction for interest on loans for qualified education expenses (sec. 221)	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Not included.
7. Temporary above-the-line deduction for higher education expenses (sec. 222)	Same as Hope credit.	Same as Hope credit.	Not included.	Not included.	Not included.
8. Exclusion for scholarships (sec. 117(a))	Included.	Included.	Included.	Not included.	Not included.
9. Exclusion for qualified tuition reduction (sec. 117(d))	Included.	Not included.	Not included.	Not included.	Not included.
10. Gift tax exclusion (sec. 2503(e))	Included.	Not included.	Not included.	Not included.	Not included.

[1] The term "special needs services" and "special needs beneficiary" are not defined in present law. Legislative history indicates that the Treasury Secretary is to define a "special needs beneficiary" to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education. Treasury has not yet issued regulations regarding this definition.

Description of Proposal

In general

The proposal provides a uniform definition of eligible hider education institution and provides more consistent definitions of qualified higher education expenses for purposes of the various provisions relating to education.

Definition of qualifying higher education institution

The proposal defines qualifying higher education institutions for purposes of provisions relating to higher education by reference to institutions eligible to participate in Federal student aid programs under Title IV of the Higher Education Act of 1965.

Tuition and fees

The proposal provides that qualifying education expenses for all education provisions include tuition and fees required for enrollment or attendance, other than: (1) expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program; (2) nonacademic fees; and (3) tuition or fees that entitle the student to any services for room or board.

Books, supplies, and equipment

With respect to those provisions that include books, supplies, and equipment as qualifying expenses under present law,[278] the proposal provides a uniform definition of such expenses. Under the proposal, for such provisions, qualifying expenses include books, supplies, and equipment required for enrollment or attendance. The definition excludes books, supplies, and equipment expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program. In addition, the amount of expenses for books, supplies, and equipment may not exceed the allowance (applicable to the student) for books and supplies included in the cost of attendance ad determined by the education institution for purposes of Federal financial aid programs. The proposal does not affect provisions that do not include books, supplies, and equipment as qualifying expenses under present law.

Special needs services

The proposal provides a definition of special needs services for those provisions that, under present law, include such services as qualifying expenses. Under the proposal, special needs services are defined as expenses incurred with respect to personal attendants (such as readers for the blind) and adaptive equipment, including adaptive computer software, incurred in connection with a student's enrollment, attendance, or courses of instruction.

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[278] These provisions are the exclusion for distributions from qualified tuition plans, the exclusion for distributions from Coverdell education savings accounts, and the exclusion for scholarships.

Room and board

With respect to the exclusion for distributions from qualified tuition plans and Coverdell education savings accounts, the proposal eliminates the two-part test for determining how much can been received tax-free with respect to such expenses. Under the proposal, distributions from such plans and accounts for room and board are excluded from income only to the extent that they do not exceed the allowance (applicable to the student) for room and board included in the cost of attendance as determined by the education institution for Federal student aid purposes. The proposal does not affect provisions that do not allow any room and board expenses as qualifying higher education expenses under present law.[279]

Analysis

Taxpayers may be easily confused by the differences between definitions of similar terms with respect to the various education provisions. Because of the variations in definitions, taxpayers may inadvertently claim benefits to which they are not entitled or fail to claim benefits to which they are entitled. The differences in definitions may also complicate record keeping for taxpayers. The varying definitions also increase administrative burdens for the IRS in trying to enforce compliance with the various provisions. The present-law rules may also increase taxpayer frustration with the Federal tax laws because the reasons for the differences in the tax treatment of certain expenses are unclear.

The staff of the Joint Committee on Taxation ("Joint Committee staff") has previously noted the complexities resulting from the differences in definitions of higher education expenses in the various education tax benefits.[280] In its statutorily mandated simplification study, the Joint Committee staff recommended that a uniform definition of qualifying education expenses should be adopted.[281]

The proposal would achieve simplification in some areas with respect to the definition of qualifying higher education expenses. By providing a uniform definition of "tuition and fees" for all provisions, six of the 10 education provisions would have the same definition of qualifying expenses. In addition, some simplification would be achieved by providing a uniform definition of "books, supplies, and equipment" for those provisions that include such items as qualifying expenses. However, because the proposal does not provide a uniform definition for all types of qualifying expenses for all provisions, taxpayers may still be confused as to whether an expense is a qualified expense under each of the provisions and therefore, as under present law, may claim benefits for which they are not entitled and fail to claim benefits for which they

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[279] The proposal also does not affect the two-prong test for room and board expenses with respect to distributions from Coverdell education accounts for elementary and secondary school expenses.

[280] 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, Volume II, at 125.

[281] *Id.* at 126.

are entitled. Further simplicity could be achieved by providing a truly uniform definition of qualified higher education expenses.

While providing a uniform definition of qualifying higher education expenses for all education provisions would provide additional simplification, it would also involve policy issues. For example, allowing room and board expenses as qualified expenses for all education tax incentives would significantly expand the scope of the education tax incentives that do not currently cover such expenses. Similarly, excluding room and board expenses from the education tax incentives that allow such expenses would significantly reduce the benefits currently provided by those provisions.

Providing a definition of special needs services may reduce disputes between taxpayers and the IRS as to what are qualifying expenses. Additional simplification could also be achieved by providing a statutory definition of a special needs beneficiary.

Eliminating the two-prong test for room and board expenses for those provisions that allow such expenses raises simplification issues and policy issues. From a simplification standpoint, the proposal may reduce disputes between taxpayers and the IRS by providing an objective standard by which to judge whether such expenses are qualified. The proposal may also ease tax administration, as well as reduce record keeping on the part of taxpayers.

From a policy perspective, the proposal may reduce the amount that may be excluded in those cases in which actual expenses for room and board exceed the allowance for such expenses. Some argue that such a result is appropriate in order to prevent taxpayer subsidy of inappropriate levels of expenses.

Prior Action

No prior action.

3. Repeal Coverdell income limits

Present Law

Section 530 of the Code provides tax-exempt status to Coverdell education savings accounts ("ESAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified education expenses of a designated beneficiary. Contributions to ESAs may be made only in cash.[282] Annual contributions to ESAs 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.

Individuals who make contributions to Coverdell education savings accounts are subject to an income limitation regarding the maximum contribution of $2,000 per year. The allowable contribution phases out between $95,000 and $110,000 of modified AGI ($190,000 to $220,000 for married taxpayers filing joint returns). There is, however, no limit on the number of accounts

[282] Special estate and gift tax rules apply to qualified tuition programs and ESAs.

that may be established for a single beneficiary. Also, persons other than individuals, e.g., corporations or charities, can make contributions up to the $2,000 per year limit with respect to any single beneficiary.

Earnings on contributions to an ESA generally are subject to tax when withdrawn. However, distributions from an ESA are excludable from the gross income of the distributee to the extent that the total distribution does not exceed the qualified 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 from an ESA, 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. In such a case, only a portion of the earnings is excludable (i.e., the portion of the earnings based on the ratio that the qualified 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 an ESA that is includible in income is generally subject to an additional 10-percent tax. The 10-percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary (to the extent it does not exceed the amount of the scholarship). Appointments to the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy are treated in the same manner as scholarships for purposes of the waiver of the additional 10 percent tax on withdrawals from ESAs that are not used for qualified education purposes.

Description of Proposal

This proposal repeals the current-law phase out of the maximum contribution that could be made to a Coverdell education savings account by individuals. Contributions may continue to be made by corporations, charitable organizations, and other entities without regard to their income. Multiple accounts may continue to be established for the same beneficiary (as long as aggregate annual contributions do not exceed $2,000).

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

Eliminating the phaseout of the maximum contribution amount would simplify the tax code by eliminating the instructions and worksheets necessary to learn about the phaseout as well as calculate the impact of the phaseout. By eliminating the phaseout, however, more taxpayers are eligible to contribute to Coverdell accounts, which for these taxpayers could complicate their tax planning as more tax-prefered saving choices would now be available to them.

Some might argue the income limits should remain in place to prevent the benefits from accruing to upper income taxpayers. However, the fact that the income limits may be avoided by having other family members with income below the limits make the contributions to the

account, and that other comparable tax free investments are available that do not have income limits (e.g., qualified tuition programs), undermines the case for maintaining the income limits in this instance.[283]

Prior Action

No prior action.

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[283] The staff of the Joint Committee on Taxation, in its statutorily mandated simplification study, recommended eliminating the phaseout for contributions to education-IRAs, as the Coverdell education savings accounts were then known. While the Joint Committee recommended elimination on the grounds that the limits were ineffective, the rationale for the staff's recommendation to eliminate other phaseouts would also apply here to the extent the phaseout was effective. 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, volume ii, at 79-91 and 586.

H. Allow Employers of Household Employees to Report and Pay Combined Federal and State Unemployment Insurance Taxes on the Form 1040

Present Law

Individuals with household employees are subject to Federal unemployment taxes (FUTA) on wages paid to such employees if total wages paid to all such employees equals at least $1,000 in any calendar quarter of the current or immediately proceeding taxable year. Household employees may include babysitters, cleaning persons and housekeepers.

Individuals with household employees may also be subject to State unemployment taxes that are required to be reported and paid quarterly to the State by the household employer. A credit against FUTA taxes is generally available for State unemployment taxes paid by the employer.

FUTA taxes on household employees are reported and paid on Schedule H for the Form 1040 of the household employer.

Description of Proposal

The proposal provides for household employers to report and pay State unemployment taxes for household employees on the household employer's Schedule H of Form 1040 rather than quarterly to the States. Therefore household employers would report and pay FICA, FUTA and income tax withheld for their household employees on Schedule H of Form 1040.

The present law requirement that household employers file employee wage and tax statements (Form W-2) and transmittal of wage and tax statements (Form W-3) is not affected by this proposal.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2004.

Analysis

The proposal eases compliance burdens on employers of household employees by consolidating the reporting and payment of State and Federal unemployment taxes on the employer's Form 1040. This proposal replaces the State quarterly reporting and tax payments of unemployment insurance taxes.

The proposal eliminates the ability of the States to individually set an income threshold for employment coverage, a ceiling on covered wages and experience ratings for household employers. Instead these levels would be set at uniform levels by the Federal government. This may reduce the State unemployment costs for some household employers but increase such costs for others.

The proposal does not alter the present law ability of the States to set unemployment benefit eligibility and benefit levels. States may adjust such levels to reflect the uniform levels

appropriate to household employees, which may affect the unemployment benefit eligibility and benefit amounts for individuals.

Prior Action

No prior action.

I. Simplify Taxation of Capital Gains of Individuals

Present Law

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

Under present law, for taxable years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain which otherwise would have been taxed at a 10- or 15-percent rate is taxed at a five-percent rate (zero for taxable years beginning in 2008). These rates apply for purposes of both the regular tax and the alternative minimum tax.[284]

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The

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[284] For taxable years beginning after December 31, 2008, the rates on the adjusted net capital gain are 20-percent and 10-percent, respectively. Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate. Another provision of the President's proposal makes the present-law lower rates permanent.

net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), the amount of gain from the sale of small business stock (described below) which is included in gross income, the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies may not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at that rate.

Small business stock

Under present law, individuals may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.[285] Seven percent of the excluded gain is a minimum tax preference. The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million.

During substantially all the taxpayer's holding period, 80 percent or more of the corporation's assets (by value) must be used in the active conduct of one or more qualified trades or businesses. Assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within two years to finance future research and experimentation, are treated as used in the active conduct of a trade or business.

A qualified trade or business is any trade or business other than (1) a trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other trades or businesses based upon the reputation or skill of one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming businesses, including raising or harvesting timber; (4) mining businesses; and (5) any business of operating a hotel, motel, or restaurant.

[285] Sec. 1202.

An individual may rollover gain from the sale of small business stock held more than six months if other small business stock is purchased within 60 days.[286]

Description of Proposal

Under the proposal, the 25- and 28-percent capital gain rates are eliminated. Instead, in the case of collectibles gain, one-half of the gain is treated as short-term capital gain; in the case of unrecaptured section 1250 gain, one-half is treated as ordinary income. Generally, the remaining one-half of the gain is taxed at the lower rates applicable to net capital gain.

Under the proposal, the provisions relating to small business stock are repealed and all gain from the sale of the stock is taxed at the lower rates generally applicable to capital gain.

Below are tables comparing the present-law tax rates for unrecaptured section 1250 gain, collectibles gain, and small business stock gain with the effective tax rates under the President's proposal.

[286] Sec. 1045.

Table 9.–Tax Rates Applicable Under Present Law to Certain Categories of Capital Gain

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**35%**	**26%**	**28%**
Unrecaptured section 1250 gain	10	15	25	25	25	25	25	25
Collectibles gain	10	15	25	28	28	28	26	28
Small business stock gain	5	7.5	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock gain	4	6	10	11.2	11.2	11.2	11.592	12.476

Table 10.–Tax Rates Applicable Under President's Proposal to Certain Categories of Capital Gain[287]

	Regular Tax Rate Bracket						Minimum Tax Rate Bracket[288]	
Category of income	**10%**	**15%**	**25%**	**28%**	**33%**	**35%**	**26%**	**28%**
Unrecaptured section 1250 gain	7.5	10	20	21.5	24	25	20.5	21.5
Collectibles gain	7.5	10	20	21.5	24	25	20.5	21.5
Small business stock gain	5	5	15	15	15	15	15	15
Empowerment zone small business stock gain	5	5	15	15	15	15	15	15

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003.

Analysis

The proposal reduces the number of lines on the tax calculation portion of schedule D that individuals with net capital gain or dividends must fill out. Also, the alternative minimum tax computation form for taxpayers with capital gains or dividends will be simplified.

[287] Under the proposal, for taxable years beginning after 2007, the tax rates in the 10- and 15-percent rate brackets will be lower than shown in the table.

[288] These rates are for taxpayers with incomes taxed in the regular tax brackets of 25-percent or higher.

The proposal treats small business stock capital gain rates the same as other stock capital gain rates. The effective rates for gain from the sale of small business stock are currently similar to the rates for other stock, taking into account the exclusion, treatment as 28-percent rate gain, and the alternative minimum tax preference. The repeal of the small business stock provisions would simplify administration of the tax law, in part, because the Internal Revenue Service may not readily know whether the corporation is a qualified small business when the tax benefits are claimed on the return of an individual shareholder.

Prior Action

No prior action.

IV. PROVISIONS RELATED TO THE EMPLOYER-BASED PENSION SYSTEM[289]

A. Proposals Relating to Cash Balance Plans

Present Law

Overview

Types of qualified plans in general

Qualified retirement plans are broadly classified into two categories, defined benefit pension plans and defined contributions plans, based on the nature of the benefits provided. In some cases, the qualification requirements apply differently depending on whether a plan is a defined benefit pension plan or a defined contribution plan.

Under a defined benefit pension plan, benefits are determined under a plan formula, generally based on compensation and years of service. For example, a defined benefit pension plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

Employer contributions to a defined benefit pension plan are subject to minimum funding requirements under the Internal Revenue Code and ERISA to ensure that plan assets are sufficient to pay the benefits under the plan. An employer is generally subject to an excise tax for a failure to make required contributions. Benefits under a defined benefit pension plan are guaranteed (within limits) by the PBGC.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (commonly called “401(k) plans” after the section of the Internal Revenue Code regulating such plans) are examples of defined contribution plans.

[289] In addition to the proposals discussed in this part, the President’s fiscal year 2005 budget proposal also states that the Administration will continue to press for enactment of the President’s retirement security plan, which includes several proposals. These proposals require that retirement plan participants receive additional information about their retirement savings, modify the fiduciary rules with respect to the provision of investment advice, and provide participants in defined contribution plans with greater diversification rights with respect to the investment of their accounts in employer securities. *See* “Safeguarding Workers' Retirement and Health Benefits Security,” Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005* (H. Doc. 108-146, Vol. I), at 229-230.

Cash balance plans

A "hybrid" plan is a plan that combines the features of a defined benefit pension plan and a defined contribution plan. In recent years, more employers have adopted cash balance plans (and other hybrid plans).

A cash balance plan is a defined benefit pension plan with benefits resembling the benefits associated with defined contribution plans. Under a cash balance plan, benefits are defined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits").

The method of determining interest credits under a cash balance plan is specified in the plan. Under one common plan design, interest credits are determined in the form of hypothetical interest on the account at a rate specified in the plan or based on a specified market index, such as the rate of interest on certain Treasury securities. Alternatively, interest credits are sometimes based on hypothetical assets held in the account, similar to earnings on an account under a defined contribution plan, which are based on the assets held in the account.[290]

Overview of qualification issues with respect to cash balance plans

Cash balance plans are subject to the qualification requirements applicable to defined benefit pension plans generally. However, because such plans have features of both defined benefit pension plans and defined contributions plans, questions arise as to the proper application of the qualification requirements to such plans. Some issues arise if a defined benefit pension plan with a traditional defined benefit formula is converted to a cash balance plan formula, while others arise with respect to all cash balance plans.[291] Issues that commonly arise include: (1) in the case of a conversion to a cash balance plan formula, the application of the rule prohibiting a cutback in accrued benefits;[292] (2) the proper method for determining lump-sum distributions;[293]

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[290] The assets of the cash balance plan may or may not include the assets or investments on which interest credits are based. As in the case of other defined benefit pension plans, a plan fiduciary would be responsible for making investment decisions with respect to cash balance plan assets.

[291] The conversion of a defined benefit pension plan to a cash balance plan generally means that the plan is amended to change the formula for accruing benefits from a traditional defined benefit formula to a cash balance formula. In such cases, the plan with the old formula and the plan as amended with the new formula are sometimes referred to as different plans, even though legally there is not a separate new plan.

[292] Code sec. 411(d)(6); ERISA sec. 204(g).

[293] Code sec. 417(e); ERISA sec. 205(g).

and (3) the application of the age discrimination rules.[294] These rules are discussed below. Other issues have been raised in connection with cash balance plans, including the proper method for applying the accrual rules.[295]

There is little guidance under present law with respect to many of the issues raised by cash balance conversions. In 1999, the IRS imposed a moratorium on determination letters for cash balance conversions pending clarification of applicable legal requirements.[296] Under the moratorium, all determination letter requests regarding cash balance plans are sent to the National Office for review; however, the National Office is not currently acting on these plans.[297]

Benefit accrual requirements[298]

In general

Several of the requirements that apply to qualified retirement plans relate to a participant's accrued benefit. For example, the vesting requirements apply with respect to a participant's accrued benefit. In addition, as discussed below, a plan amendment may not have the effect of reducing a participant's accrued benefit. In the case of a defined benefit pension plan, a participant's accrued benefit is generally the accrued benefit determined under the plan, expressed in the form of an annuity commencing at normal retirement age.[299]

The accrued benefit to which a participant is entitled under a defined benefit pension plan must be determined under a method (referred as the plan's accrual method) that satisfies one of three accrual rules. These rules relate to the pattern in which a participant's normal retirement benefit (i.e., the benefit payable at normal retirement age under the plan's benefit formula) accrues over the participant's years of service, so that benefit accruals are not "back-loaded" (i.e., delayed until years of service close to attainment of normal retirement age).

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[294] Code sec. 411(b)(1)(G) and (H); ERISA sec. 204(b)(1)(G) and (H); Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. 623(i).

[295] Code sec. 411(b); ERISA sec. 204(b).

[296] Announcement 2003-1, 2003-2 I.R.B. 281.

[297] *Id.*

[298] Code sec. 411(b); ERISA sec. 204(b).

[299] Code sec. 411(a)(7). If a plan does not provide an accrued benefit in the form of an annuity commencing at normal retirement age, the accrued benefit is an annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit determined under the plan. Treas. Reg. sec. 1.411(a)-7(a)(1)(ii).

Application of accrual rules to cash balance plans

Cash balance plans may be categorized based on when the benefits attributable to interest credits accrue. Under one type of plan, referred to as a "front-loaded interest credit plan," future interest credits to an employee's hypothetical account balance are not conditioned upon future service. Under a front-loaded plan, the benefits attributable to future interest credits with respect to a hypothetical allocation accrue at the same time that the benefits attributable to the hypothetical allocation accrue. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account.

A second type of cash balance plan (referred to as a "back-loaded" plan) conditions future interest credits upon future service. In the case of a back-loaded plan, benefits attributable to interest credits do not accrue until the interest credits are credited to the employee's account. The IRS has indicated that, because back-loaded interest credit plans typically will not satisfy any of the accrual rules, any future IRS guidance will address only frontloaded interest credit plans.

Protection of accrued benefits; "wearaway" under cash balance plans

In general

The Code generally prohibits an employer from amending a plan's benefit formula to reduce benefits that have already accrued (the "anticutback rule").[300] For this purpose, an amendment is treated as reducing accrued benefits if it has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy or of eliminating an optional form of benefit.[301]

The anticutback rule applies in the context of cash balance plan conversions. Because of this rule, after conversion to a cash balance formula, a plan must provide employees with the normal and early retirement benefit that he or she had accrued before the conversion.[302] However, the plan may determine benefits for years following the conversion in a variety of ways, while still satisfying the anticutback rule. Common plan designs are discussed below.

Wearaway (or "greater of" approach)

Upon a conversion to a cash balance plan, participants are given an opening account balance. The pay and interest credits provided under the plan are then added to this opening account balance. The opening account balance may be determined in a variety of ways and is

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[300] Code sec. 411(d)(6); ERISA sec. 204(g). The provisions do not, however, protect benefits that have not yet accrued but would have in the future if the plan's benefit formula had not changed.

[301] Code sec. 411(d)(6)(B); ERISA sec. 204(g)(2).

[302] Certain other plan features, such as early retirement subsidies, must also be protected.

generally a question of plan design. For example, an employer may create an opening account balance that is designed to approximate the benefit a participant would have had, based on the participant's compensation and years of service, if the cash balance formula had been in effect in prior years. As another example, an employer may convert the preconversion accrued benefit into a lump-sum amount and establish this amount as the opening account balance. Depending on the interest and mortality assumptions used, this lump-sum amount may or may not equal the actuarial present value of the participant's accrued benefit as of the date of conversion, determined using the statutory interest and mortality assumptions required for lump-sum calculations.

Under a "wearaway" approach, a participant does not accrue any additional benefits after the conversion until the participant's benefits under the cash balance formula exceed the participant's preconversion accrued benefit. Because of this effect, plans with a wearaway are also referred to as using the "greater of" method of calculating benefits. Plan design can greatly affect the length of any wearaway period.

Under the wearaway approach, the participant's protected benefit is compared to the normal retirement benefit[303] that is provided by the account balance (plus pay and interest credits), and the participant does not earn any new benefits until the new benefit exceeds the protected accrued benefit.[304] For example, suppose the value of the protected accrued benefit is $40,000, and the opening account balance under the cash balance formula provides a normal retirement benefit of $35,000. The participant will not earn any new benefits until the hypothetical balance under the cash balance formula increases to the extent that it provides a normal retirement benefit exceeding $40,000.

<u>No wearaway (or "sum of " approach)</u>

Under a plan without a wearaway, a participant's benefit under the cash balance plan consists of the sum of (1) the benefit accrued before conversion plus (2) benefits under the cash balance formula for years of service after the conversion. This approach is more favorable to plan participants than the wearaway approach, because they earn benefits under the new plan formula immediately. This approach is also sometimes referred to as the "A + B" method, where A is the protected benefit and B is the benefit under the cash balance formula.

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[303] These rules apply to normal retirement benefits. Other issues may arise with respect to wearaway of early retirement benefits.

[304] In some cases, the plan may convert the protected benefit into a lump-sum equivalent for purposes of the opening account balance. Even if at the time of the initial calculation the opening balance equals the value of the protected benefit, the account balance may not continue to reflect the value of the protected benefit over time, depending on the actuarial assumptions used. Thus, a cash balance plan may not rely on the cash balance formula to protect accrued benefits because it may encounter problems under the anticutback rule (depending on the actuarial assumptions used).

Grandfathering

For older and longer-service participants, benefits under a cash balance formula may be lower than the benefits a participant may have expected to receive under the traditional defined benefit formula (the "old" formula).[305] The employer might therefore provide some type of "grandfather" to participants already in the plan or to older or longer-service employees. For example, the participants might be given a choice between the old formula and the cash balance formula for future benefit accruals, or, in the case or a final average pay plan, the plan may stop crediting service under the old formula, but continue to apply post-conversion pay increases, so the employee's preconversion benefit increases with post-conversion pay increases. This approach goes beyond preserving the benefit protected by the anticutback rules.

Calculating lump-sum distributions

Defined benefit pension plans are required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age.[306] If the plan permits benefits to be paid in another form, e.g., a lump-sum distribution, the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age, determined using certain statutorily prescribed interest and mortality assumptions.

Although a participant's benefit under a cash balance plan is described in terms of a hypothetical account balance, like other defined benefit pension plans, a cash balance plan is required to provide benefits in the form of an annuity payable at normal retirement age. Most cash balance plans are designed to permit lump-sum distributions of the participant's hypothetical account balance upon determination of employment. As is the case with defined benefit pension plans generally, such a lump-sum amount is required to be the actuarial equivalent to the annuity payable at normal retirement age, determined using the statutory interest and mortality assumptions.

IRS Notice 96-8 provides that determination of an employee's minimum lump sum under a cash balance plan which provides for frontloaded interest credits is calculated by: (1) projecting the participant's hypothetical account balance to normal retirement age by crediting future interest credits, the right to which has already accrued; (2) converting the projected account balance to an actuarially equivalent life annuity payable at normal retirement age, using the interest and mortality assumptions specified in the plan; and (3) determining the present value of the annuity (i.e., the lump-sum value) using the statutory interest and mortality assumptions.[307]

A difference in the rate of interest credits provided under the plan, which may be used to project the account balance forward to normal retirement age, and the statutory rate used to determine the lump-sum value (i.e., present value) of the accrued benefit will cause a

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[305] This is sometimes the reduction in benefits that is referred to in connection with cash balance conversions, i.e., a reduction in expected benefits, not accrued benefits.

[306] Code sec. 401(a)(11); ERISA sec. 205.

[307] Section III.B and C of Notice 96-8, 1996-1 C.B. 359 (Feb. 5, 1996).

discrepancy between the value of the minimum lump-sum and the employee's hypothetical account balance. In particular, if the plan's interest crediting rate is higher than the statutory interest rate, then the resulting lump-sum amount will be greater than the hypothetical account balance. This result is sometimes referred to as "whipsaw." Several Federal appellate courts have addressed the calculation of lump-sum distributions under cash balance plans and have all followed the approach as described in IRS Notice 96-8.[308]

Age discrimination

In general, the Code prohibits reductions in the benefit accrual rates (including the cessation of accruals) for defined benefit pension plan participants on account of attainment of any age.[309] Similarly, the Code prohibits a defined contribution plan from ceasing allocations, or reducing the rate at which amounts are allocated to a participant's account due to attainment of any age. Parallel requirements exist in ERISA and the Age Discrimination in Employment Act ("ADEA").[310]

These provisions do not necessarily prohibit all benefit formulas under which a reduction in accruals is correlated with participants' age in some manner. Thus, for example, a plan may limit the total amount of benefits, or may limit the years of service or participation considered in determining benefits.[311]

In general terms, an age discrimination issue arises under cash balance plans because there is a longer time for interest credits to accrue on hypothetical contributions to the account of a younger participant. For example, a $1,000 hypothetical contribution made when a plan participant is age 30 will be worth more at normal retirement age (e.g., age 65) and thus provide a higher annuity benefit at normal retirement age than the same contribution made on behalf of an older participant closer to normal retirement age. This age discrimination issue is not limited to cash balance plan conversions, but arises with respect to cash balance plans generally. Other age discrimination issues may also arise, depending in part on plan design, e.g., whether the plan has a "wearaway" (described below).

In December 2002, the Treasury Department issued proposed regulations relating to the application of age discrimination prohibitions to defined benefit pension plans, including special rules for cash balance plans.[312] Under the proposed regulations, subject to certain requirements,

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[308] *See Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), *cert. dismissed*, 531 U.S. 1061 (2001); *Lyons v. Georgia-Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000), *cert. denied*, 532 U.S. 967 (2001).

[309] Code sec. 411(b)(1)(H).

[310] ERISA sec. 204(b)(1)(H); ADEA, 29 U.S.C. Code sec. 623(i).

[311] Code sec. 411(b)(1)(H)(ii); ERISA sec. 204(g)(1)(H)(ii).

[312] 67 Fed. Reg. 76123 (Dec. 11, 2002). Prop. Treas. Reg. Code sec. 1.411(b)-2. The proposed regulations provide guidance on how to determine the rate of benefit accrual under a

a cash balance formula that provides all participants with the same rate of pay credit generally will not violate the prohibition on age discrimination. In the case of a plan that is converted to a cash balance plan, the conversion generally must be accomplished in one of two ways in order to use the special rule. That is, in general, the converted plan must either: (1) determine each participant's benefit as not less than the sum of the participant's benefits accrued under the traditional defined benefit pension plan formula and the cash balance formula; or (2) establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's prior accrued benefit, using reasonable actuarial assumptions. The proposed regulations also allow a converted plan to continue to apply the traditional defined benefit formula to some participants.

After the proposed regulations were issued, a Federal district court in *Cooper v. IBM Personal Pension Plan*[313] held that that cash balance formulas are inherently age discriminatory because identical interest credits necessarily buy a smaller age annuity at normal retirement age for older workers than for younger workers due to the time value of money. Prior to the decision in *IBM*, other district courts had reached the contrary result, i.e., that the cash balance formula was not age discriminatory.[314]

Section 205 of the Consolidated Appropriations Act, 2004 (the "Appropriations Act"),[315] enacted January 24, 2004, provides that none of the funds made available in the Appropriations Act may be used by the Secretary of the Treasury, or his designee, to issue any rule or regulation implementing the proposed Treasury regulations or any regulation reaching similar results. Additionally, the Appropriations Act requires the Secretary of the Treasury within 180 days of enactment to present to Congress a legislative proposal for providing transition relief for older and longer-service participants affected by conversions of their employers' traditional pension plans to cash balance plans. The proposal is intended to satisfy this requirement.

Description of Proposal

In general

The proposal provides rules for conversions of defined benefit pension plans to cash balance plans, prescribes age discrimination requirements for cash balance plans, and specifies rules for calculating lump-sum distributions from cash balance plans. The proposal makes conforming amendments to applicable rules under ERISA and ADEA.

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defined benefit plan or rate of allocation under a defined contribution plan. The proposed regulations also address a number of other issues, including nondiscrimination testing for cash balance plans under section 401(a)(4). In April 2003, the Treasury Department announced it would withdraw the proposed regulations under section 401(a)(4). Announcement 2003-22, 2002-17 I.R.B. 846 (April 28, 2003).

[313] 274 F. Supp. 2d 1010 (S.D. Ill. 2003).

[314] *See, e.g., Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

[315] Pub. L. No. 108-199 (2004).

Conversions to cash balance plans; wearaway

Under the proposal, for the first five years following the conversion of a traditional defined benefit pension plan to a cash balance plan, the benefits earned by any participant in the cash balance plan who was a participant in the traditional plan must be at least as valuable as the benefits the participant would have earned under the traditional plan had the conversion not occurred. Additionally, wearaway of normal and early retirement benefits in connection with a conversion to a cash balance plan is prohibited.

Failure to follow these requirements will not result in disqualification of the plan. However, a 100-percent excise payable by the plan sponsor will be imposed on any difference between required benefits and the benefits actually provided under a plan which has been converted to a cash balance formula. The amount of the excise tax cannot exceed the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income, whichever is greater. The excise tax does not apply if participants are given a choice between the traditional defined benefit pension plan formula and the cash balance formula or if current participants are "grandfathered," i.e., permitted to continue to earn benefits under the traditional formula rather than the cash balance formula.

Age discrimination

Under the proposal, a cash balance plan satisfies age discrimination requirements if it provides pay credits for older participants that are not less than the pay credits for younger participants (in the same manner as under a defined contribution plan). Additionally, certain transition approaches used in conversions, such as preserving the value of early retirement subsidies, do not violate the age discrimination or other qualification rules. The proposal provides similar rules for other types of hybrid plans and for conversions from traditional defined benefit pension plans to other types of hybrid plans.

Calculating lump-sum distributions

The proposal permits the value of a lump-sum distribution to be determined as the amount of a participant's hypothetical account balance under a cash balance plan as long as the plan does not provide interest credits in excess of a market rate of return. The Secretary of the Treasury is authorized to provide safe harbors for market rates of return and to prescribe appropriate conditions regarding the calculation of plan distributions.

Effective date

The proposal is effective prospectively. No inference is intended as to the status of cash balance plans or cash balance conversions under present law.

Analysis

In general

In addressing certain legal issues relating to cash balance plans, the proposal has three stated objectives: to ensure fairness for older workers in cash balance conversions, to protect the

defined benefit pension plan system by clarifying the status of cash balance plans, and removing the effective ceiling on interest credits in cash balance plans due to the way lump-sum benefits are calculated. Specific issues arise with respect to each part of the proposal. In addition, the proposal raises broader issues relating to the defined benefit pension plan system and retirement income security.

Retirement income security and cash balance plans

Helping to ensure that individuals have retirement income security is the major objective of the U.S. private pension system. The system is a voluntary system, relying heavily on tax incentives in order to encourage employers to establish qualified retirement plans for their employees. Although qualified plans are subject to a variety of legal requirements, employers generally may choose whether or not to adopt a qualified plan, the type of plan to adopt, the level of benefits to be provided, and many other plan features.

Over time, there has been a decline in defined benefit pension plan coverage compared to coverage under defined contribution plans. This has caused some to be concerned about a possible decline in retirement income security, and has focused attention on both defined contribution plans and defined benefit pension plans. Issues of retirement income security with respect to both types of plans have been the subject of recent Congressional hearings.[316]

Traditional defined benefit pension plans are viewed by many as providing greater retirement income security than defined contribution plans. This is primarily because such plans provide a specific promised benefit. Employers bear the risk of investment loss; if plan contributions plus earnings are insufficient to provide promised benefits, the employer is

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[316] The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means held a hearing on challenges facing pension plan funding on April 30, 2003; *see* Joint Committee on Taxation, *Present Law and Background Relating to the Funding Rules for Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation ("PBGC")* (JCX-39-03), April 29, 2003; the Senate Committee on Finance held a hearing on issues relating to the funding of defined benefit plans on March 11, 2003; *see* Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation ("PBGC")* (JCX-16-03), March 10, 2003; the Subcommittee on Oversight of the House Committee on Ways and Means held a hearing on retirement security and defined benefit pension plans on June 20, 2002; *see Joint Committee on Taxation, Present Law and Background Relating to Employer-Sponsored Defined Benefit Plans* (JCX-71-02), June 18, 2002; the Senate Committee on Finance held a hearing on issues related to retirement security on February 27, 2002; *see* Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements and Proposals Regarding Defined Contribution Plans* (JCX-11-02), February 26, 2002; and the House Committee on Ways and Means held a hearing on Issues Related to Retirement Security and Defined Contribution Plans on February 26, 2002; *see* Joint Committee on Taxation*, Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements* (JCX-9-02), February 25, 2002.

responsible for making up the difference. Within certain limits, most defined benefit pension plan benefits are guaranteed by the PBGC. Investments of defined benefit pension plan assets are subject to ERISA's fiduciary rules and limitations on the amount of plan assets that may be invested in stock of the employer. In addition, defined benefit pension plans are subject to certain spousal benefit requirements that do not apply to most defined contribution plans. That is, defined benefit plans are required to provide benefits in the form of a joint and survivor annuity, unless the participant and spouse consent to another form of benefit.

In contrast, defined contribution plans do not promise a specific benefit, but instead pay the value of the participant's account. The plan participant bears the risk of investment loss. Benefits provided by defined contribution plans are not guaranteed by the PBGC. The extent to which ERISA's fiduciary rules apply to a defined contribution plan depends on the particular plan structure; in many cases defined contribution plans allow plan participants to direct the investment of their accounts, in which case more limited fiduciary protections apply than in the case of defined benefit pension plans. ERISA's limitations on the amount of plan assets that may be invested in employer stock generally do not apply to defined contribution plans. In addition, under most defined contribution plans, the spouse has only the right to be named the beneficiary of the amount (if any) remaining upon the death of the employee.

Cash balance plans have become an increasing prevalent plan design and, as well, an increasing element in discussions regarding retirement income security and the future of the defined benefit plan system.

During the 1990s, conversions of traditional defined benefit pension plans to cash balance formulas were common among mid- to large-size employers. There was considerable media attention regarding such conversions, particularly in cases in which the plan contained a "wearaway" or in which older or longer-service employees close to retirement were denied the opportunity to continue to accrue benefits under the old plan formula. While perhaps complying with the law, such plan designs were viewed by many as unfair to certain participants. There was concern that some employers were adversely affecting participants in order to reduce costs. There was also concern that participants might not understand the effect of the conversion on their benefits (including future benefits the participant may have accrued under the old formula).[317]

The proposal addresses three common issues that have been raised with respect to cash balance plans. In the case of two of the issues, the calculation of lump-sum benefits and age discrimination, the proposal codifies current employer practices with respect to cash balance plans. By providing certainty with respect to some aspects of cash balance plans, and by allowing such plans to continue in their current form, the proposal will help make cash balance plans a viable plan design for many employers.

Many view preserving cash balance plans as a means of preserving the defined benefit pension plan system, and as an important step in helping to ensure retirement income security.

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[317] These concerns led to the enactment of the present-law notice requirements regarding future reductions in benefit accruals. Code sec. 4980F and ERISA sec. 204(h).

Those who hold this view argue that cash balance plans are more beneficial to many employees than a traditional defined benefit pension plan and should be a permitted plan design option.

Unlike traditional defined benefit pension plans, which tend to benefit long-service participants who remain with a company until retirement, cash balance plans often benefit shorter service, more mobile workers. Cash balance plans also provide a more portable benefit than the traditional defined benefit pension plan. Thus, cash balance plans may be popular in industries or markets in which workers are relatively mobile or among groups of workers who go in and out of the workforce. Some participants also find cash balance plans easier to understand than a traditional defined benefit pension plan--their benefit statement shows an account balance.

The adoption of a cash balance plan may be beneficial from the employer's perspective. Some employers are concerned about the level of contributions that may be required to fund traditional defined benefit pension plans, especially if the required contributions may fluctuate over time. They argue that a cash balance plan design makes it easier for employers to manage pension liabilities. The easier it is for an employer to manage pension liabilities, the more likely it is that an employer may adopt or continue a plan.

On the other hand, some are concerned that cash balance plans are primarily adopted by employers who wish to cut costs and reduce future benefits. They argue that reductions in benefits are not as obvious with a conversion to a cash balance plan compared to plan changes within the traditional defined benefit pension plan structure. Even with the present-law requirements relating to notices of reductions in future benefit accruals, it is argued that plan participants do not understand how to compare cash balance benefits with traditional defined benefit pension plan benefits and that many employees mistakenly think that the cash balance formula, expressed as an account balance, provides comparable benefits when it does not. It is also argued that cash balance plans inherently discriminate against longer service older workers, and thus should not be encouraged as a plan design.

It is countered that if an employer wishes to reduce benefits, or eliminate benefits altogether, they could do so within the traditional defined benefit pension plan structure. Moreover, some argue, employers generally sponsor qualified retirement plans voluntarily; tax incentives encourage employers to establish and maintain such plans but they are not required to do so. It is argued that the flexibility allowed by employers by cash balance plans enables employers to continue a defined benefit pension plan, as well as in many cases also provide a defined contribution plan, thus enhancing retirement income security.

Some also note that cash balance plans, while legally defined benefit pension plans, operate in a way that does not deliver the full protections of a traditional defined benefit pension plan. For example, many traditional defined benefit pension plans do not offer lump-sum distributions. In contrast, cash balance plans typically do. While some argue that this increases portability of benefits, others argue that cash balance plans discourage annuity benefits, which may erode retirement income security and may undermine spousal rights.

Some also comment that the risk of investment loss borne by employers, and the protections against such losses for employees, are fundamentally different in cash balance plans than in traditional defined benefit pension plans. In particular, it is argued that the risk

employees bear under a cash balance plan is more like the risk they bear under a defined contribution plan. In the case of a traditional defined benefit plan, the plan formula promises a benefit, payable at normal retirement age. The employer bears the risk that plan assets will not be sufficient to provide the promised benefits and generally must make up investment losses. Rather than providing a specified benefit, a cash balance plan specifies interest credits. The employer bears the risk that plan assets will underperform compared to the interest credits provided under the plan.

The concern that cash balance plan participants face risk similar to the risk under defined contribution plans is enhanced to the extent that the hypothetical account balance in a cash balance plan is subject to investment losses and well as investment gains. While many cash balance plans are designed to protect against loss in value, others argue that it is permissible to tie interest credits to hypothetical investments that may incur losses. Some argue that such declines are inconsistent with the basic concept of a defined benefit pension plan, i.e., a plan that provides a specified benefit to participants, in contrast to a defined contribution plan under which participants bear the risk of loss. They argue that cash balance plan designs under which participants bear the risk of investment loss (even if only on hypothetical investments) should not be permitted.

Some argue that to the extent proposals relating to cash balance plans are motivated by concerns about retirement income security that other proposals to address such concerns should also be considered. For example, some argue that addressing issues with respect to funding of traditional defined benefit pension plans would help make such plans more attractive to employers on an on-going basis. Some also argue that it may be appropriate to consider whether changes to the rules relating to defined contribution plans should be considered to enable such plans to provide greater retirement income security.

Conversions to cash balance plans; wearaway

The proposal is intended to ensure fairness for older workers in conversions of traditional defined benefit pension plans to cash balance plans. It provides rules relating to the benefits accrued by participants in defined benefit pension plans which are converted to cash balance plans. The proposal provides greater protection for longer-service participants than is currently required under the present-law rules prohibiting cut backs in accrued benefits.

By requiring that the benefits earned by a participant for the first five years following a conversion must be at least as valuable as the benefits the participant would have earned under the traditional plan had the conversion not occurred, participants in the plan who are close to retirement age are better protected against disadvantages of converting to a cash balance plan. Further, by prohibiting wearaway in a conversion to a cash balance plan with respect to the benefits of such participants, possible adverse effects on older and longer-service participants will be reduced.

On the other hand, some argue that the proposal does not go far enough in ensuring that older and longer service employees will not be disadvantaged. Some argue that all plan participants, or at least participants who have attained a certain age or number of years of service, should automatically be given the greater of benefits under the old plan formula or under

the new plan formula. Others argue that any such additional requirement would cause employer qualified retirement plan costs to increase, and could cause employers to reduce benefits further or terminate existing plans. They argue that the proposal provides an appropriate balance between concerns about older workers and the need to provide flexibility to employers in order to maintain the voluntary pension system.

Some argue that the 100-percent excise tax on any difference between required benefits and the benefits actually provided under a plan which has been converted to a cash balance formula is sufficient to encourage compliance with the proposal. However, others argue that limiting the amount of the excise tax to the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income, whichever is greater, will allow plan sponsors to manipulate the timing of a conversion so that the requirements of the proposal can be avoided without imposition of the excise tax. They argue that absent the potential for plan disqualification, the efficacy of the proposal is diminished, or even eliminated.

Some argue that the proposal provides appropriate flexibility to employers and additional safeguards for employees, by allowing employers to avoid the excise tax by grandfathering participants under the old formula or giving employees a choice between the old and new formula. On the other hand, some point out that giving employees options increases complexity for plan participants, and that many participants may not adequately understand the differences between the new plan formula and the old plan formula. These concerns may be addressed, at least to some extent, by requiring that participants receive sufficient information to make an informed decision. As mentioned above, others would go further, and require that at least some employees be automatically given the greater of the two formulas. This would avoid the need for elections, and the possibility that an employee may unwittingly choose an option that is clearly worse than the old plan formula. On the other hand, some view such a requirement as unduly restricting employers options in plan design.

Age discrimination

By providing that cash balance plans satisfy the age discrimination rules if the plan provides pay credits for older participants that are not less than the pay credits for younger participants, the proposal provides certainty in this regard. Some have argued that if such certainty is not provided, employers will be disinclined to offer defined benefit pension plans, including cash balance plans, to their employees. By reducing uncertainty as to how cash balance plans can meet age discrimination requirements, some would argue that employers will be more likely to sponsor (or continue to sponsor) defined benefit pension plans, including cash balance plans. Some, however, argue that pay credits for younger participants in cash balance plans are inherently discriminatory and for this, and other reasons, cash balance plans should not be encouraged. These issues are discussed more fully above in the discussion of present law, under the heading "Age discrimination."

The proposal lacks specificity with respect to certain transition strategies and other types of hybrid plans. Additional issues may arise depending on the specifics of such proposals.

Calculating lump-sum distributions

The proposal is intended to eliminate situations in which the amount of a minimum lump-sum distribution required from a cash balance plan is greater than a participant's hypothetical account balance because the plan's interest crediting rate is higher than the statutory interest rate. The proposal departs from the analysis set out in IRS Notice 96-8 and followed by several Federal courts that have considered this issue.

Proponents argue that the cases are based on IRS rulings that pre-date the prevalence of cash balance plans and that apply rules that are inappropriate in a cash balance context. Further, they argue that, as a result of the present-law rules, employers have reduced the amount of interest credits under cash balance plans, thus reducing benefits for participants. The proposal avoids this result and thus, it is argued, will benefit plan participants by encouraging employers to use a higher rate of return that the statutorily-prescribed rate.

In order for the proposal to apply, the plan must not use interest credits in excess of a market rate of return, and the Secretary is to provide safe harbors as to what is a market rate. This aspect of the proposal raises issues as to how to determine a market rate of return. Recent discussions over what constitutes an appropriate replacement for the interest rate on 30-year Treasury obligations for purposes related to defined benefit pension plans reflects the degree of complexity which may be involved in prescribing such safe harbors. The effects of the proposal on plan benefits, and the ease with which the proposal can be implemented by employers, understood by employees, and administered by the IRS will depend in large part on the ability to determine measures of market rates of returns. Some argue that because so much depends on what is a market rate of return under the proposal, it would be more appropriate to provide statutory guidance on this issue, rather than leave the issue for the Secretary to resolve.

Complexity

As a result of its study of Enron Corporation, performed at the direction of the Senate Committee on Finance, the staff of the Joint Committee on Taxation ("Joint Committee staff") found that the lack of guidance with respect to cash balance plan conversions and cash balance plans generally creates uncertainty for employers and employees. The Joint Committee staff recommended that clear rules for such plans should be adopted in the near future.[318]

The budget proposals help to reduce uncertainty with respect to cash balance plans by addressing certain issues that frequently arise with respect to cash balance plans. However, the proposals do not address all issues with respect to such plans. In addition, certain aspects of the proposals need further clarification, or may add some additional complexities. For example, additional clarification is needed with respect to types of transition approaches in conversions which do not violate age discrimination or other qualification rules, allowing participants to choose between a traditional defined benefit formula and cash balance formula in order to avoid

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[318] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, at 487.

the 100-percent excise tax, and the determination of a market rate of return for purposes of calculating lump-sum distributions.

Prior Action

No prior action.

B. Improve the Accuracy of Pension Liability Measures

Present Law

In general

Under present law, the interest rate on 30-year Treasury securities is used for several purposes related to defined benefit pension plans. Specifically, the interest rate on 30-year Treasury securities is used: (1) in determining current liability for purposes of the funding and deduction rules; (2) in determining unfunded vested benefits for purposes of Pension Benefit Guaranty Corporation ("PBGC") variable rate premiums; and (3) in determining the minimum required value of lump-sum distributions from a defined benefit pension plan and maximum lump-sum values for purposes of the limits on benefits payable under a defined benefit pension plan.

The IRS publishes the interest rate on 30-year Treasury securities on a monthly basis. The Department of the Treasury does not currently issue 30-year Treasury securities. As of March 2002, the IRS publishes the average yield on the 30-year Treasury bond maturing in February 2031 as a substitute.

Funding rules

In general

The Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act of 1974 ("ERISA") impose minimum funding requirements with respect to defined benefit pension plans.[319] Under the funding rules, the amount of contributions required for a plan year is generally the plan's normal cost for the year (i.e., the cost of benefits allocated to the year under the plan's funding method) plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit.

Additional contributions for underfunded plans

Under special funding rules (referred to as the "deficit reduction contribution" rules),[320] an additional contribution to a plan is generally required if the plan's funded current liability percentage is less than 90 percent.[321] A plan's "funded current liability percentage" is the

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[319] Code sec. 412; ERISA sec. 302. The Code also imposes limits on deductible contributions, as discussed below.

[320] The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

[321] Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for

actuarial value of plan assets[322] as a percentage of the plan's current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan.

The amount of the additional contribution required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below), over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits.[323] The amount of the additional contribution cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

The deficit reduction contribution is the sum of (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.[324] The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but is reduced if the plan's funded current liability percentage is greater than 60 percent.

Required interest rate and mortality table

Specific interest rate and mortality assumptions must be used in determining a plan's current liability for purposes of the special funding rule. The interest rate used to determine a

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each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

[322] The actuarial value of plan assets is the value determined under an actuarial valuation method that takes into account fair market value and meets certain other requirements. The use of an actuarial valuation method allows appreciation or depreciation in the market value of plan assets to be recognized gradually over several plan years. Sec. 412(c)(2); Treas. reg. sec. 1.412(c)(2)-1.

[323] A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. An additional contribution is generally not required with respect to unpredictable contingent event benefits unless the event giving rise to the benefits has occurred.

[324] If the Secretary of the Treasury prescribes a new mortality table to be used in determining current liability, as described below, the deficit reduction contribution may include an additional amount.

plan's current liability must be within a permissible range of the weighted average[325] of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. The permissible range is generally from 90 percent to 105 percent.[326] The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.[327]

The Job Creation and Worker Assistance Act of 2002[328] amended the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements. Under this provision, the permissible range is from 90 percent to 120 percent for plan years beginning after December 31, 2001, and before January 1, 2004.

The Secretary of the Treasury is required to prescribe mortality tables and to periodically review (at least every five years) and update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.[329] The Secretary of the Treasury has required the use of the 1983 Group Annuity Mortality Table.[330]

Full funding limitation

No contributions are required under the minimum funding rules in excess of the full funding limitation. In 2004 and thereafter, the full funding limitation is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the lesser of (a) the

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[325] The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period. Notice 88-73, 1988-2 C.B. 383.

[326] If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

[327] Code sec. 412(b)(5)(B)(iii)(II); ERISA sec. 302(b)(5)(B)(iii)(II). Under Notice 90-11, 1990-1 C.B. 319, the interest rates in the permissible range are deemed to be consistent with the assumptions reflecting the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.

[328] Pub. L. No. 107-147.

[329] Code sec. 412(l)(7)(C)(ii); ERISA sec. 302(d)(7)(C)(ii).

[330] Rev. Rul. 95-28, 1995-1 C.B. 74. The IRS and the Treasury Department have announced that they are undertaking a review of the applicable mortality table and have requested comments on related issues, such as how mortality trends should be reflected. Notice 2003-62, 2003-38 I.R.B. 576; Announcement 2000-7, 2000-1 C.B. 586.

market value of plan assets or (b) the actuarial value of plan assets.[331] However, the full funding limitation may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limitation may be based on projected future benefits, including future salary increases.

Timing of plan contributions

In general, plan contributions required to satisfy the funding rules must be made within 8½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.[332] The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[333]

Deductions for contributions

Employer contributions to qualified retirement plans are deductible, subject to certain limits. In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for

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[331] For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a percentage (170 percent for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the full funding limitation based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[332] Code sec. 412(m); ERISA sec. 302(e).

[333] In connection with the expanded interest rate range available for 2002 and 2003, special rules apply in determining current liability for the preceding plan year for purposes of applying the quarterly contributions requirements to plan years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability percentage for the preceding year, which may affect the need to make quarterly contributions, and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over ten years, but limited to the full funding limitation for the year.[334] However, the maximum amount of deductible contributions is generally not less than the plan's unfunded current liability.[335]

PBGC premiums

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. The PBGC generally insures the benefits owed under defined benefit pension plans (up to certain limits) in the event the plan is terminated with insufficient assets. Employers pay premiums to the PBGC for this insurance coverage.

PBGC premiums include a flat-rate premium and, in the case of an underfunded plan, a variable rate premium based on the amount of unfunded vested benefits.[336] In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the annual yield on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Under the Job Creation and Worker Assistance Act of 2002, for plan years beginning after December 31, 2001, and before January 1, 2004, the interest rate used in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes is increased to 100 percent of the annual yield on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Lump-sum distributions

Accrued benefits under a defined benefit pension plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form. Defined benefit pension plans generally provide that a participant may choose among other forms of benefit offered under the plan, such as a lump-sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.

A defined benefit pension plan must specify the actuarial assumptions that will be used in determining optional forms of benefit under the plan in a manner that precludes employer discretion in the assumptions to be used. For example, a plan may specify that a variable interest

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[334] Code sec. 404(a)(1).

[335] Sec. 404(a)(1)(D). In the case of a plan that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program (sometimes referred to as "termination liability").

[336] ERISA sec. 4006.

rate will be used in determining actuarial equivalent forms of benefit, but may not give the employer discretion to choose the interest rate.

Statutory assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum.[337] That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to the life annuity payable to the participant, determined using the statutory assumptions. The statutory assumptions consist of an applicable mortality table (as published by the IRS) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of the time that is permitted under regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant ("stability period") and the use of averaging.

Limits on benefits

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $165,000 (for 2004).[338] The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning no earlier than age 62. The limit is reduced if benefits are paid before age 62. In addition, if the benefit is not in the form of a straight life annuity, the benefit generally is adjusted to an equivalent straight life annuity. In making these reductions and adjustments, the interest rate used generally must be not less than the greater of: (1) five percent; or (2) the interest rate specified in the plan. However, for purposes of adjusting a benefit in a form that is subject to the minimum value rules (including the use of the interest rate on 30-year Treasury securities), such as a lump-sum benefit, the interest rate used must be not less than the greater of: (1) the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan.

Description of Proposal

In general

The proposal replaces the interest rate on 30-year Treasury securities with the rate of interest on high-quality corporate bonds for purposes of determining a defined benefit pension plan's current liability for funding purposes[339] and determining the value of lump sums payable

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[337] Code sec. 417(e)(3); ERISA sec. 205(g)(3).

[338] Code sec. 415(b).

[339] The proposal does not provide for a change in the interest rate used to determine unfunded vested benefits for purposes of PBGC variable rate premiums.

from such a plan. The proposal also requires the freezing of benefit accruals and the suspension of lump-sum distributions in the case of certain underfunded defined benefit pension plans.[340]

Interest rates used in determining current liability and lump sums

For plan years beginning in 2004 and 2005, the interest rate used to determine a plan's current liability must be within a permissible range (from 90 percent to 100 percent) of the weighted average of the yields on high-quality long-term corporate bonds. The average is determined for the 48 months ending with the month preceding the first day of the plan year.

Beginning in 2008, a plan's current liability is determined using a series of interest rates drawn from a yield curve of high-quality zero-coupon bonds with various maturities. The maturities used to determine a plan's current liability are selected to match the amounts and timing of benefit payments expected to be made from the plan. The yield curve is to be issued monthly by the Secretary of the Treasury and is to be based on the 90-day average of interest rates for high-quality corporate bonds.

For plan years beginning in 2006 and 2007, a plan's current liability is determined as the weighted average of two values: (1) the value of the plan's current liability determined using the methodology applicable for plan years beginning in 2004 and 2005 (the "old" methodology); and (2) the value of the plan's current liability determined using the methodology applicable for 2008 and thereafter (the "new" methodology). For plan years beginning in 2006, the weighting factor is 2/3 for the current liability value determined under the old methodology and 1/3 for the current liability value determined under the new methodology. For plan years beginning in 2007, the weighting factors are reversed.

For plan years beginning in 2004 and 2005, the proposal does not change the law relating to the determination of minimum and maximum lump sums from defined benefit pension plans (e.g., minimum lump-sum values are determined using the rate of interest on 30-year Treasury securities). Beginning in 2008, the proposal provides that minimum and maximum lump-sum values are to be calculated using rates drawn from the zero-coupon corporate bond yield curve. Thus, the interest rate that applies depends on how many years in the future a participant's annuity payment will be made. Typically, a higher interest rate applies for payments made further out in the future.

For distributions in 2006 and 2007, lump-sum values are determined as the weighted average of two values: (1) the value of the lump sum determined using the methodology under present law (the "old" methodology); and (2) the value of the lump sum determined using the methodology applicable for 2008 and thereafter (the "new" methodology). For distributions in

[340] In addition to these proposals, the President's fiscal year 2005 budget includes a proposal to provide better information about the financial status of pension plans to plan participants, retirees, and investors. *See*, "Safeguarding Workers' Retirement and Health Benefits Security," Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005* (H. Doc. 108-146, Vol. I), pp. 229-230, and *Appendix* (H. Doc. 108-146, Vol. II), pp. 716-717.

2006, the weighting factor is 2/3 for the lump-sum value determined under the old methodology and 1/3 for the lump-sum value determined under the new methodology. For distributions in 2007, the weighting factors are reversed.

Limits on benefit accruals and lump-sum distributions under certain plans

Under the proposal, in the case of a defined benefit pension plan sponsored by an employer with a credit rating below investment grade, accrued benefits under the plan are required to be frozen if the value of the plan's assets is less than 50 percent of termination liability under the plan. That is, no additional benefit accruals are permitted in those circumstances.[341] In addition, the availability of lump-sum distributions under the plan is required to be suspended, as well as other forms of accelerated benefit payments, including the purchase of annuities.

Effective date

The proposal is generally effective for plan years beginning in 2004 and thereafter. The requirement that accrued benefits be frozen and lump-sum distributions suspended in the case of certain underfunded plans is effective for plan years beginning in 2005 and thereafter.

Analysis

In general

Almost all changes to pension laws require the balancing of competing policy objectives, including concerns regarding retirement income security, simplification, reduction of administrative burdens, and fiscal and tax policy. In some cases, a single policy concern may result in competing issues. For example, concerns regarding retirement income security may lead to the enactment of stricter rules; however, if the new rules are too severe, plan sponsors may modify plans or reduce benefits, thereby potentially reducing retirement security.

The funding rules are a cornerstone of the defined benefit pension plan system and, over time, have been a frequent source of discussion and change. Like many of the qualified retirement plan rules, proposals relating to the funding rules involve balancing competing policy interests.

Policy issues relating to the funding and deduction rules for defined benefit pension plans

As discussed above, present law imposes minimum funding requirements with respect to defined benefit pension plans and a limit on the maximum amount of deductible contributions. In addition, nondeductible contributions are discouraged through the imposition of an excise tax. Contributions in excess of the amount needed to provide plan benefits are also discouraged through the restrictions on reversions of plan assets.

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[341] Service continues to be credited under the plan for purposes of vesting and eligibility for benefits.

The minimum funding rules are designed to promote benefit security by helping to ensure that plan assets will be sufficient to pay promised benefits when due. The minimum funding rules also address moral hazard concerns relating to the PBGC insurance program by preventing employers from purposely underfunding plans. Such underfunding can increase costs to the Federal government as well as PBGC premium payors.

On the other hand, the minimum funding rules recognize that pension benefits are often long-term liabilities that can be funded over a period of time. Some argue that if minimum funding requirements are too stringent, funds may be unnecessarily diverted from the employer's other business needs and may cause financial problems for the business, thus jeopardizing the future of not just the employees' retirement benefits, but also their jobs. This suggestion tends to arise during a period of economic downturn, either generally or in a particular industry. Some also argue that overly stringent funding requirements may discourage the establishment or continuation of defined benefit pension plans.

The limits on deductible contributions, the excise tax on nondeductible contributions, and the rules relating to reversions of defined benefit pension plan assets have as a major objective preventing the use of defined benefit pension plans as a tax-favored funding mechanism for the business needs of the employer. They also serve to limit the tax expenditure associated with defined benefit pension plans. Some argue that if the maximum limits on plan funding are too low, then benefit security will be jeopardized. They argue that employers need flexibility to make greater contributions when possible, in order to ensure adequate funding in years in which the business may not be as profitable. In addition, some argue that if restrictions on reversions are too strict, employers may be discouraged from making contributions in excess of the required minimums.

The desire to achieve the proper balance between these competing policy objectives has resulted in a variety of legislative changes to address the concerns arising at particular times. For example, the Omnibus Budget Reconciliation Act of 1987 made comprehensive changes to the minimum funding rules (including enactment of the deficit reduction contribution rules) prompted by concerns regarding the solvency of the defined benefit pension plan system. That Act also added the current liability full funding limit. Legislation enacted in 1990 allowed employers access to excess assets in defined benefit pension plans in order to pay retiree health liabilities. The Retirement Protection Act of 1994 again made comprehensive changes to the funding rules. Recent changes to the funding rules have focused on increasing the maximum deductible contribution, and on the interest rate that must be used to calculate required contributions. For example, EGTRRA increased the current liability full funding limit and then repeals the current liability full funding limit for 2004 and thereafter.

Background relating to interest rate used to measure pension liabilities

Recent attention has focused on the issue of the rate of interest used to determine the present value of benefits under defined benefit pension plans for purposes of the plan's current liability (and hence the amount of contributions required under the funding rules) and the amount of lump-sum benefits under the plan. The theoretical basis for the interest rate to be used to determine the present value of pension plan benefits is an interest rate that would be used in setting the price for private annuity contracts that provide similar benefits. Some studies have

shown that it is not practicable to identify such a rate accurately because of variation in the manner in which prices of private annuity contracts are determined. As a result, the interest rate used to value pension benefits is intended to approximate the rate used in pricing annuity contracts.[342] Some have described this standard as a rate comparable to the rate earned on a conservatively invested portfolio of assets.

Under present law, the interest rate used for these purposes is based on the interest rate on 30-year Treasury obligations. The interest rate issue has received attention recently in part because the Treasury Department stopped issuing 30-year obligations. As a result, there is no longer a 30-year Treasury interest rate, and statutory changes are necessary to reflect this. In addition, as discussed below, concerns have been raised that the 30-year Treasury rate was too low compared to annuity purchase rates and therefore caused inappropriate results.

For plan funding purposes, the use of a lower interest rate in determining current liability results in a higher present value of the benefits and larger contributions required to fund those benefits. Alternatively, the use of a higher interest rate results in a lower present value of future liabilities and therefore lower required contributions. Because minimum lump-sum distributions are calculated as the present value of future benefits, the interest rate used to calculate this present value will affect the value of the lump-sum benefit. Specifically, the use of a lower interest rate results in larger lump-sum benefits; the use of a higher interest rate results in lower lump-sum benefits.

Some have argued that the 30-year Treasury rate has been too low compared to annuity rates, resulting in inappropriately high levels of minimum funding requirements on employers that are not necessary to maintain appropriate retirement income security. In addition, some argue that the 30-year Treasury rate has been so low as to make lump-sum benefits disproportionately large in comparison with a life annuity benefit payable under the plan, thus providing an incentive for employees to take benefits in a lump sum rather than in the form of a life annuity. Some argue that lump sums should not be favored as a form of benefit, because they can cause a cash drain on the plan. In addition, an annuity assures the individual of an income stream during retirement years, which may not be available in the case of a lump-sum payment, depending on what use the individual makes of the payment (e.g., whether the individual spends the lump sum currently or uses the funds to purchase an annuity).

Some have pointed out that a variety of policy issues relating to the funding requirements may arise in the context of the interest rate discussion, and that some of these issues are better resolved through means other than the interest rate. For example, recent declines in defined benefit pension plan assets have adversely affected the funded status of many plans, resulting in what some view as unduly burdensome funding requirements on employers. Some in favor of funding relief believe it should be provided through interest rate adjustments. Others argue that, if funding relief is desired, it would be better to prescribe a more theoretically correct interest

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[342] In practice, the price of an annuity contact encompasses not only an interest rate factor but also other factors, such as the costs of servicing the contract and recordkeeping. Under present law, the interest rate used for determining current liability is intended to embody all of these factors. *See* H.R. Rpt. No. 100-495, at 868 (1987).

rate, and make other changes in the minimum funding requirements. They suggest that this type of approach would provide relief to employers without resulting in potentially inappropriate results in other cases, e.g., in determining lump-sum benefits. On the other hand, some argue that funding relief is not appropriate at all, and that higher contributions should be required in order to increase funding levels, thereby enhancing retirement security and reducing potential PBGC liabilities.

Other issues that may arise in the context of the interest rate discussion include employer flexibility in making contributions and the appropriate level of tax benefits for defined benefit pension plans.[343] For example, a given employer may prefer a lower interest rate that enables the employer to make large deductible contributions and thereby maximize the tax benefit from maintaining the plan. Alternatively, another employer may prefer a higher rate that would reduce required contributions, thus freeing up funds for other business uses. Some argue that the degree of flexibility in contributions to be provided to employers should be addressed through means other than the choice of interest rate.

Analysis of interest-rate proposal

Under the proposal, the rate of interest on 30-year Treasury securities is replaced with the rate of interest on high-quality corporate bonds for purposes of determining a plan's current liability and determining minimum and maximum lump-sum values. Initially, the interest rate used to determine current liability is based on a weighted average of the yields on high-quality long-term corporate bonds. After a transition period, in determining current liability and lump-sum values, the proposal provides for the use of a series of interest rates drawn from a yield curve of high-quality zero-coupon bonds with various maturities, selected to match the timing of benefit payments expected to be made from the plan.

Some believe that, compared with the rate of interest on 30-year Treasury securities, an interest rate based on corporate bonds better approximates the rate that would be used in determining the cost of settling pension liabilities, i.e., by purchasing annuity contracts to provide the benefits due under the plan. However, some argue for an interest rate index based on Treasury or other Federal agency obligations (with an adjustment as necessary to approximate annuity rates) out of concern that a rate based on a privately determined index could be improperly manipulated because the elements on which the index is based, such as the bonds on which a corporate bond index is based, may not be known (i.e., the rate is not "transparent") or because those elements are subject to change by the organization determining the index. Some who favor the use of an interest rate based on corporate bonds have raised similar transparency concerns with respect to the Secretary of the Treasury's determination of the interest rate applicable for pension purposes. It has been suggested that the Secretary of the Treasury should be required to explain the methodology to be used to determine such interest rate and to make public the corporate bond indices on which the rate is based.

[343] A tax benefit results from the prefunding of the retirement benefit, which produces tax-free inside buildup on the earnings from the assets held by the plan.

Some have suggested that use of any single interest rate is inappropriate, and rather that multiple interest rates should be used to reflect the varying times when benefits become payable under a plan, because of, for example, different expected retirement dates of employees. The rationale for this approach is that interest rates differ depending, in part, on the term of an obligation.[344] A graph of this relationship is known as a "yield curve." Because plan liabilities may be payable both in the short term and the long term, this approach determines the present value of these liabilities with multiple interest rates, chosen to match the times at which the benefits are payable under the plan. The proposal to use a corporate bond yield curve to determine the present value of benefits is consistent with these views and is intended to improve the accuracy of pension liability measures.

Some have raised concerns that a yield-curve approach is more complicated than the use of a single rate, particularly for smaller plans and for purposes of determining lump-sum distributions. Some have suggested that this could have the effect of increasing administrative costs associated with maintaining a defined benefit pension plan and discourage the continuation and establishment of such plans. Some have also suggested that the use of a yield curve to determine minimum and maximum lump-sum distributions may make it more difficult for plan participants to understand and evaluate their distribution options under the plan.

Others have responded to these concerns by suggesting that, although a single interest rate is used to determine required contributions under the present-law funding rules, a yield-curve approach is commonly used for other purposes, such as corporate finance. Some also note that the determination of current liability and lump-sum values already involve the application of complicated actuarial concepts (particularly the determination of current liability) and the proposal does not add significant complexity. They argue moreover that any additional complexity is outweighed by the importance of measuring pension liabilities accurately, including the timing of benefit payments from the plan. In addition, it has been suggested that simplified methods (such as the use of a single composite rate) can be provided for smaller plans and for purposes of determining lump-sum distributions.

The proposal also eliminates the four-year averaging period used to determine the interest rate applicable for purposes of determining current liability under present law. Some have suggested that such an averaging period is necessary to prevent rapid interest rate changes from causing corresponding changes in current liability, which in turn may result in volatility in the amount of minimum required and maximum deductible contributions. Others believe that the interest rate used to value pension liabilities should be designed to measure those liabilities as accurately as possible and that volatility in required contributions and deductible contributions should be addressed through modifications to the funding and deduction rules.

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[344] In general, longer term bonds provide a higher interest rate, and shorter term bonds a lower interest rate.

Proposal relating to limits on benefit accruals and lump-sum distributions under certain underfunded plans

Under the proposal, additional benefit accruals and lump-sum distributions are precluded in the case of a plan sponsored by an employer with a credit rating below investment grade if the value of the plan's assets is less than 50 percent of termination liability under the plan. Some argue that, if an employer has failed to adequately fund the benefits already earned under a plan and also presents a measurable risk of going out of business while the plan is underfunded, it is inappropriate to allow plan liabilities to increase as a result of additional accruals or for plan assets to be depleted by lump-sum distributions. They argue that such a plan presents an undue risk to the PBGC that the plan will terminate and that insufficient assets will be available (from the plan or from the employer) to provide benefits due under the plan. Accordingly, the proposal limits the PBGC's potential liability in such circumstances.

Others argue that it is not unusual for an employer to experience temporary financial problems that do not in fact threaten the long-term viability of the employer's pension plan. They also argue that limiting benefit accruals and distributions from the plan as required under the proposal unfairly penalizes plan participants and may cause unnecessary concern about their retirement income security. On the other hand, if the employer's financial problems are in fact temporary and the funded status of the plan improves, benefit accruals and lump-sum distributions may resume and plan participants can be made whole.

Prior Action

H.R. 3108, the "Pension Funding Equity Act of 2003," as passed by the House of Representatives on October 8, 2003, includes a provision under which, for plan years beginning after December 31, 2003, and before January 1, 2006, for purposes of determining current liability, the interest rate on 30-year Treasury securities is replaced with the rate of interest on amounts conservatively invested in long-term corporate bonds. On January 28, 2004, the Senate passed an amendment to H.R. 3108, the "Pension Stability Act," which contains a similar provision.

The National Employee Savings and Trust Equity Guarantee Act, as ordered reported by the Committee on Finance on September 17, 2003, and (with amendments) on February 2, 2004, includes a provision relating to the interest rate used to determine current liability and lump-sum distributions. Under that provision, for plan years beginning after December 31, 2003, and before January 1, 2007, for purposes of determining current liability, the interest rate on 30-year Treasury securities is replaced with the rate of interest on amounts invested in conservative long-term corporate bonds. For plan years beginning after December 31, 2010, for purposes of determining current liability and lump-sum distributions, the interest rate on 30-year Treasury securities is replaced with a yield curve reflecting interest rates on corporate bonds of durations the rate of interest on amounts invested in conservative long-term corporate bonds. Phase-in rules apply for years beginning after December 31, 2006, and before January 1, 2011.

V. TAX SHELTERS, ABUSIVE TRANSACTIONS AND TAX COMPLIANCE

A. Proposals Designed to Combat Abusive Tax Avoidance Transactions

1. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[345]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[346] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[347]

The second category is any transaction that is offered under conditions of confidentiality. The second category is any transaction that is offered under conditions of confidentiality and for which the taxpayer has paid the advisor a minimum fee. A transaction is considered to be offered under conditions of confidentiality if the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of the advisor's tax strategies. The minimum fee is $250,000 for a transaction if the taxpayer is a corporation and $50,000 for all other transactions not involving a corporation.[348]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the

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[345] On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003 are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

[346] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1-6011-4(c)(4).

[347] Treas. Reg. sec. 1.6011-4(b)(2).

[348] Treas. Reg. sec. 1.6011-4(b)(3).

transaction are not sustained, or (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[349]

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[350]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[351]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[352]

Under present law, there is no specific penalty for failing to disclose a reportable transaction. However, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[353]

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[349] Treas. Reg. sec. 1.6011-4(b)(4).

[350] Treas. Reg. sec. 1.6011-4(b)(5). Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

[351] Treas. Reg. sec. 1.6011-4(b)(6). The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $250 million or more in gross assets. Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

[352] Treas. Reg. sec. 1.6011-4(b)(7).

[353] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. However, Treas. Reg. sec. 1.6664-4(d) provides that the failure to disclose a reportable transaction that results in a tax understatement is a "strong indication" that the taxpayer did not act in good faith with respect to the transaction.

Description of Proposal

In general

The proposal imposes a penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction.

Penalty rate

Under the proposal, a taxpayer failing to disclose a reportable transaction will be subject to a penalty in the following amounts: (1) for corporate taxpayers with respect to listed transactions, $200,000 and five percent of any underpayment resulting from the listed transaction; (2) for corporate taxpayers with respect to other reportable transactions, $50,000; (3) for partnerships, S corporations, and trusts, $200,000 with respect to listed transactions and $50,000 with respect to other reportable transactions; (4) for individual taxpayers with respect to listed transactions, $100,000 and five percent of any underpayment resulting from the listed transaction; and (5) for individual taxpayers with respect to other reportable transactions, $10,000.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify.

Effective date

The proposal generally is effective after the date of enactment.

2. Disclosure of reportable transactions by material advisors

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[354] A "tax shelter" means any investment with respect to which the tax shelter ratio[355] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State

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[354] Sec. 6111(a).

[355] The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[356]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[357]

A transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[358] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[359] Certain exceptions are provided with respect to the second category of transactions.[360]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[361]

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[362] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the

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[356] Sec. 6111(c).

[357] Sec. 6111(d).

[358] Treas. Reg. sec. 301.6111-2(b)(2).

[359] Treas. Reg. sec. 301.6111-2(b)(3).

[360] Treas. Reg. sec. 301.6111-2(b)(4).

[361] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances. If an offeree's disclosure of the tax treatment or tax structure of the transaction is limited in any way by an express or implied understanding or agreement with (or for the benefit of) any tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

[362] Sec. 6707.

greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Description of Proposal

Disclosure of reportable transactions

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires that an information return be filed with respect to any entity, investment plan or arrangement or other plan or arrangement that is of a type determined by the Treasury Department to have the potential for tax avoidance or evasion. The proposal also modifies present-law to confirm that the requirements and penalties may apply to all organizers and sellers of reportable transactions, including persons who assist such persons.

Penalty for failing to furnish information regarding reportable transactions

The proposal repeals the present law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction. The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the fees paid to the promoter. Intentional disregard by a material advisor of the requirement to disclose a reportable transaction increases the penalty to 75 percent of the fees paid to the promoter.

Effective date

The proposal generally is effective after the date of enactment.

3. Investor lists and modification of penalty for failure to maintain investor lists

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to

confidentiality restrictions).[363] Recently finalized regulations under section 6112 provide rules regarding the list maintenance requirements.[364]

The final regulations provide that, for this purpose, a potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the new final regulations under section 6011), or (3) a potential material advisor (at the time the transaction is entered into or an interest is acquired) knows or reasonably expects will become a reportable transaction (as defined under the new final regulations under section 6011).[365]

The regulations define an organizer or seller of a potentially abusive tax shelter as any person who is a material advisor with respect to that transaction.[366] A "material advisor" is defined as any person who (1) directly or indirectly receives, or is expected to receive, a minimum fee of (a) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (b) $50,000 for any other transaction that is a potentially abusive tax shelter, and (2) makes or provides a statement to any person regarding the potential tax consequences of the transaction.[367] A material advisor also includes any person that is required to register the transaction under section 6111.

The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[368]

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

Description of Proposal

Investor lists

Each person required to file an information return with respect to a reportable transaction[369] is required to maintain a list that (1) identifies each person with respect to whom

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[363] Sec. 6112.

[364] Treas. Reg. sec. 301.6112-1.

[365] Treas. Reg. sec. 301.6112-1(b).

[366] Treas. Reg. sec. 301.6112-1(c)(1).

[367] Treas. Reg. sec. 301.6112-1(c)(1) and (2).

[368] Sec. 6112(c)(2).

the advisor acted as an organizer or seller (or a person who assisted an organizer or seller) with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the Secretary is authorized (but not required) to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[370]

Effective date

The proposal generally is effective after the date of enactment.

4. Actions to enjoin conduct with respect to tax shelters and reportable transactions

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[371]

Description of Proposal

The proposal expands this rule to confirm that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[372] and the keeping of lists of investors by material advisors.[373] Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish

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[369] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

[370] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

[371] Sec. 7408.

[372] Sec. 6707, as amended by other proposals of this package.

[373] Sec. 6708, as amended by other proposals of this package.

upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective date.–The proposal generally is effective after the date of enactment.

5. Penalty for failure to report interests in foreign financial accounts

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that individual engages in a transaction, or maintains an account, with a foreign financial entity.[374] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Treasury Department, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[375] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[376]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[377] This report, which was statutorily required,[378] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

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[374] 31 U.S.C. 5314.

[375] 31 U.S.C. 5321(a)(5).

[376] 31 U.S.C. 5322.

[377] *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001,* April 26, 2002.

[378] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

Description of Proposal

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to $5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective date.–The proposal generally is effective after the date of enactment.

6. Foreign tax credit transactions

Present Law

The United States provides a credit for foreign income taxes paid or accrued. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves the purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income. This overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S.-source and foreign-source taxable income. Separate limitations are applied to specific categories of income.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

Description of Proposal

The proposal expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. In addition, the proposal authorizes the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.

The proposal also provides regulatory authority for the Treasury Department to address certain transactions that involve the inappropriate separation of foreign taxes from the related

foreign income in cases where taxes are imposed on any person in respect of income of an entity. This proposal responds to certain foreign tax credit structures that allow taxpayers to manipulate the foreign tax credit rules in a manner inconsistent with providing relief from double taxation.[379]

Effective date.–The proposal generally is effective after the date of enactment.

7. Income separation transactions

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[380]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of income stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).[381] However, there are no specific statutory rules that address income stripping

[379] *See, e.g.,* cross-border tax arbitrage transactions described in Notice 98-5, 1998-1 C.B. 334, *withdrawn by* Notice 2004-19, 2004-11 I.R.B. 1.

[380] *Helvering v. Horst*, 311 U.S. 112 (1940).

[381] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

transactions with respect to common stock or other equity interests (other than preferred stock).[382]

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[383] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[384] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[385] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes either the stripped bond or one or more stripped coupons must allocate pre-disposition basis in the bond (with the coupons attached) between the retained and disposed items.[386] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to

[382] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

[383] Sec. 1286.

[384] Sec. 1286(e).

[385] Sec. 1286(a).

[386] Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[387]

Stripped preferred stock

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[388] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[389] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[390]

Mineral production payments

Production payments that are carved out of mineral property and disposed generally are treated as mortgage loans on the property, rather than economic interests in the property.[391] Conversely, production payments that are retained upon the disposition of a mineral property generally are treated as purchase money mortgage loans, rather than economic interests in the property.[392] Thus, whereas the present-law treatment of stripped bonds and stripped preferred

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[387] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[388] Sec. 305(e)(5).

[389] Sec. 305(e)(1).

[390] Sec. 305(e)(3).

[391] Sec. 636(a). For this purpose, a "production payment" generally is defined as a right to a specified in-kind share of the production from mineral in place (if, as, and when produced), or the cash proceeds from such production. The term also includes any right that is in substance economically equivalent to a production payment. However, the term includes only economic interests in mineral in place. In addition, the term includes only rights with an expected economic life, at the time that the right is created, that is shorter in duration than the economic life of the underlying mineral property. Treas. Reg. sec. 1.636-3.

[392] Sec. 636(b).

stock respects the separation of interest or dividend rights from the underlying bond or stock (while recharacterizing the tax consequences of such transactions), the present-law treatment of carved-out or retained mineral production payments recharacterizes the separation transaction itself as a secured borrowing (rather than respecting the separation of production payments from mineral property and treating such payments as economic interests in the property).

Description of Proposal

The proposal treats an income separation transaction as a secured borrowing, rather than as a separation of ownership, such that the tax treatment of the transaction clearly reflects income. The proposal does not define the term "income separation transaction."

Effective date.–The proposal generally is effective after the date of enactment.

Analysis of the Proposals Designed to Combat Abusive Tax Avoidance Transactions

Policy issues

Individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax. Such a phenomenon poses a serious threat to the efficacy of the tax system because of both the potential revenue loss and the potential threat to the integrity of the self-assessment system.

On March 21, 2002, the Senate Committee on Finance heard testimony from Treasury Department and IRS officials that only 272 transactions by 99 different taxpayers were disclosed under the present law for the 2001 tax-filing season. In connection with the hearing, the Treasury Department announced a new initiative ("Treasury shelter initiative") that is designed to provide the government with the tools necessary to respond to abusive tax avoidance transactions.[393] The President's budget proposals to combat abusive tax avoidance transactions generally are similar to the proposals that were contained in the Treasury shelter initiative.

The proposals emphasize combating abusive transactions by requiring increased disclosure of such transactions by all parties involved. Clearly, greater disclosure is necessary if the IRS is expected to respond to these transactions in a timely and meaningful manner. However, there is some concern regarding whether increased disclosure, in and of itself, will be sufficient to deter taxpayers from engaging in tax avoidance transactions. A motivated corporation can manipulate the technical provisions of the law to achieve significant unintended benefits. Such a taxpayer often obtains tax opinion letters from sophisticated tax advisors, and uses exceedingly complicated structures and a myriad of entities to obfuscate the essential elements of the transaction. These factors, coupled with a taxpayer's assertion of attorney-client privilege to impede the IRS's ability to understand and analyze the transaction, cast doubt on any proposal the effectiveness of which depends heavily on increased disclosure.

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[393] *See generally, "The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions*," (March 20, 2002).

The substantive proposals regarding foreign tax credit holding period requirements and income separation transactions appear to respond to certain specific categories of tax avoidance transactions in which taxpayers either acquire foreign tax credits or generate immediate tax losses while converting current ordinary income into deferred capital gain. In each case, it may be difficult to develop specific operative rules that appropriately distinguish between legitimate transactions and abusive transactions.

The foreign tax credit proposal related to the inappropriate separation of foreign taxes from the related foreign income would expand existing regulatory authority to allow the Treasury Department and IRS to address the second class of transactions described in Notice 98-5 as well as other abusive transactions involving foreign tax credits.[394] The proposal gives the Treasury Department broad authority to stop foreign tax credit abuses, but does not identify in great detail the scope of transactions that would be covered. The proposal states that the types of transactions involved vary and, therefore, the regulations could provide for either the disallowance of a credit for all or a portion of the foreign taxes, or the allocation of the foreign taxes among the participants to the transaction in a manner that is more consistent with the underlying economics of the transaction. If such regulatory authority were granted, the effectiveness of these rules would depend upon the Treasury Department providing greater detail with respect to the scope of transactions covered and exactly how such transactions would be curtailed.

Complexity issues

The proposals regarding increased disclosure of tax avoidance transactions can be expected to increase the complexity of the tax law. The difficulty in identifying and defining the types of transactions that will require disclosure means that taxpayers will have to consider the application of these rules to a potentially broad class of transactions. However, the Treasury Department is focusing its efforts on limiting the types of transactions that will require disclosure so that amount of disclosure requested by the Treasury Department is not burdensome.

The substantive proposals regarding foreign tax credit transactions and income separation transactions also can be expected to increase the complexity of the tax law. Appropriately tailoring the scope of these proposals potentially will entail the development of complex rules that taxpayers would need to examine and apply in order to determine whether a particular transaction is subject to these proposals. In addition, determining the tax consequences of transactions that are subject to these proposals potentially will require complex rules that are flexible enough to accommodate a wide variety of circumstances without producing unintended or unwarranted results.

Prior Action

As previously noted, the proposals (except for the proposal concerning foreign tax credit separation transactions) generally were contained in a Treasury shelter initiative released in March 2002. In addition, these proposals generally were included in the President's Fiscal Year

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[394] *See* Notices 2004-19 and 2004-20, 2004-11 I.R.B. 1.

2004 Budget Proposal. During 2002, 2003 and 2004, several legislative proposals have included various aspects of these proposals.[395]

[395] *See*, *e.g.*, Joint Committee on Taxation, *Description of the "Highway Reauthorization and Excise Tax Simplification Act of 2004"* (JCX-5-04), January 29, 2004; House Ways and Means Committee Report of H.R. 2896, *American Jobs Creation Act of 2003*, (H. Rep. 108-393, November 21, 2003); Senate Finance Committee Report of S. 1637, *Jumpstart our Business Strength (JOBS) Act*, (S. Rep. 108-192, November 7, 2003); Jobs and Growth Tax Relief Reconciliation Act of 2003 (H.R. 2), as passed by the Senate on May 15, 2003.

B. Limit Related-Party Interest Deductions

Present Law

A U.S. corporation with a foreign parent may reduce the U.S. tax on its U.S.-source income through the payment of deductible amounts such as interest, rents, royalties, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments. Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments, this may be reduced or eliminated under an applicable income tax treaty. Consequently, U.S. corporations may use certain treaties to facilitate earnings stripping transactions without having their deductions offset by U.S. withholding taxes.

Generally, present law limits the ability of U.S. corporations[396] to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) generally disallows a deduction for so called "disqualified interest" paid or accrued by a corporation in a taxable year, if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor"); and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such interest or (2) unrelated parties in certain instances in which a related party guarantees the debt ("guaranteed debt").

Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Description of Proposal

The proposal eliminates from present law the safe harbor and the carryforward of excess limitation. In addition, the proposal reduces the present-law threshold of 50 percent of adjusted taxable income to 25 percent with respect to interest on related-party debt. With respect to interest on guaranteed debt, the present-law threshold of 50 percent of adjusted taxable income is retained. The carryforward of disallowed interest is limited to 10 years.

Effective date.–The proposal is effective on the date of first committee action.

Analysis

Recent inversion transactions led some to question the efficacy of the present-law earnings stripping rules.[397] In some cases, it appeared that the earnings stripping benefit

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[396] Although section 163(j) most commonly applies to U.S. corporations, it can apply to foreign corporations.

[397] *See, e.g.,* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003, 104 ("Under current law, opportunities are

achieved when a U.S. corporation paid deductible amounts to its new foreign parent or other foreign affiliates constituted the primary intended tax benefit of the transaction.[398] The proposal would further limit the opportunities for earnings stripping by reducing the adjusted taxable income threshold from 50 percent to 25 percent for interest on related-party debt and limiting the indefinite carryforward of disallowed interest to 10 years. In addition, the proposal eliminates the safe harbor and the three-year carryforward of excess limitation.

The proposal does not address, however, earnings stripping transactions involving the payment of deductible amounts other than interest (e.g., rents, royalties, and service fees) or the payment of deductible amounts by taxpayers other than corporations. These transactions may also erode the U.S. tax base. Accordingly, some may argue that a more comprehensive response to earnings stripping transactions is needed.

In contrast, others argue there is no empirical evidence of abuse outside the context of inversion transactions, and thus, the proposal is too broad because it tightens the rules of section 163(j) outside the inversion context. As a result of its breadth, the proposal may penalize legitimate transactions. For example, the capital structures of multinational companies often vary by line of business and the amount of leverage the market permits. The proposal does not take these differences into account.[399] Others may be concerned that the proposal may cause foreign-based multinationals to reduce their direct investments in the United States because the proposal may increase the cost of such investments. Some may argue that the proposal needs to provide that the amount of interest expense allowed is consistent with arm's-length principles. Others may argue that guaranteed debt does not increase the likelihood of base erosion as compared with non-guaranteed debt because borrowers typically obtain guarantees to reduce the interest rate on a loan and such interest is paid to an unrelated third party.[400] Although the proposal does not tighten the earnings stripping rules with respect to guaranteed debt, some may

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available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications,* May 17, 2002, Part VII.A ("Treasury study") ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited").

[398] *See, e.g.,* Treasury study, Part VII.A; Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, 3-4.

[399] The President's Fiscal Year 2004 Budget Proposal contained a section 163(j) proposal, which included a replacement of the safe harbor with a new safe harbor based on a series of debt-to-asset ratios that varied by asset class.

[400] However, the rules for guaranteed debt under section 163(j) are often described as a backstop to the earnings stripping rules on related-party debt because guaranteed debt may serve as a substitute for a direct loan from a foreign affiliate to a U.S. corporation, which would be subject to section 163(j).

argue that it should relax the rules for guaranteed debt relative to current law.[401] Lastly, the proposal is not entirely clear as to how the different percentage thresholds for interest on related-party debt and interest on guaranteed debt apply.

Prior Action

H.R. 2896, the "American Jobs Creation Act of 2003," contains a similar earnings-stripping proposal. Generally, H.R. 2896 eliminates the debt-equity threshold and the carryover of excess limitation; carryovers of disallowed interest are limited to 10 years; the "adjusted taxable income" percentage threshold is lowered from 50 percent to 25 percent with respect to related-party debt.

In contrast, the President's fiscal year 2004 budget proposal contained an earnings stripping proposal that changed present law by modifying the safe harbor provision, reducing the adjusted taxable income threshold, adding a new disallowance provision based on a comparison of domestic to worldwide indebtedness, and limiting carryovers.

Changes to the earnings stripping rules also were discussed in the Treasury study of May 2002,[402] and were included in H.R. 5095, the "American Competitiveness and Corporate Accountability Act of 2002." H.R. 5095 proposed several changes to section 163(j) and added a new interest disallowance rule that disallowed related-party interest to the extent that the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide corporate group.

S. 1637, the "Jumpstart our Business Strength Act," and the Senate amendment to H.R. 2, the "Jobs and Growth Tax Relief Reconciliation Act of 2003, tightened the earnings stripping rules only for certain inverted companies.

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[401] S. 1475, the "Promote Growth and Jobs in the USA Act of 2003," would relax the current law rules with respect to guaranteed debt. Under S. 1475, interest on guaranteed debt would fall outside the definition of "disqualified interest" in the case of a guarantee by a foreign person if the taxpayer established to the satisfaction of the Secretary that the taxpayer could have borrowed substantially the same principal amount from an unrelated person without the guarantee.

[402] *See* Treasury study, Part VII.A.

C. Modify Qualification Rules for Tax-Exempt Property and Casualty Insurance Companies

Present Law

Qualification rules for tax-exempt property and casualty insurance companies

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832).

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed $350,000 (sec. 501(c)(15)).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed $350,000, but do not exceed $1.2 million (sec. 831(b)).

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account. For this purpose, a more-than-50-percent threshhold applies under the vote and value requirements with respect to stock ownership for determining a controlled group, and rules treating a life insurance company as part of a separate controlled group or as an excluded member of a group do not apply (secs. 501(c)(15), 831(b)(2)(B) and 1563).

Definition of insurance company

Present law provides specific rules for taxation of the life insurance company taxable income of a life insurance company (sec. 801), and for taxation of the taxable income of an insurance company other than a life insurance company (sec. 831) (generally referred to as a property and casualty insurance company). For Federal income tax purposes, a life insurance company means an insurance company that is engaged in the business of issuing life insurance and annuity contracts, or noncancellable health and accident insurance contracts, and that meets a 50-percent test with respect to its reserves (sec. 816(a)). This statutory provision applicable to life insurance companies explicitly defines the term "insurance company" to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)).

The life insurance company statutory definition of an insurance company does not explicitly apply to property and casualty insurance companies, although a long-standing Treasury regulation[403] that is applied to property and casualty companies provides a somewhat similar

[403] The Treasury regulation provides that "the term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

definition of an "insurance company" based on the company's "primary and predominant business activity."[404]

When enacting the statutory definition of an insurance company in 1984, Congress stated, "[b]y requiring [that] more than half rather than the 'primary and predominant business activity' be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies . . . Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities."[405]

Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code." Treas. Reg. section 1.801-3(a)(1).

[404] Court cases involving a determination of whether a company is an insurance company for Federal tax purposes have examined all of the business and other activities of the company. In considering whether a company is an insurance company for such purposes, courts have considered, among other factors, the amount and source of income received by the company from its different activities. *See Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182 (1932); *United States v. Home Title Insurance Co.*, 285 U.S. 191 (1932). *See also Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), in which the court concluded that the company was not an insurance company: "The . . . financial data clearly indicates that petitioner's primary and predominant source of income was from its investments and not from issuing insurance contracts or reinsuring risks underwritten by insurance companies. During each of the years in issue, petitioner's investment income far exceeded its premiums and the amounts of earned premiums were de minimis during those years. It is equally as clear that petitioner's primary and predominant efforts were not expended in issuing insurance contracts or in reinsurance. Of the relatively few policies directly written by petitioner, nearly all were issued to [family members of the owners]. Also, Investment Life, in which [family members] each owned a substantial stock interest, was the source of nearly all of the policies reinsured by petitioner. These facts, coupled with the fact that petitioner did not maintain an active sales staff soliciting or selling insurance policies . . . , indicate a lack of concentrated effort on petitioner's behalf toward its chartered purpose of engaging in the insurance business. . . . For the above reasons, we hold that during the years in issue, petitioner was not 'an insurance company . . . engaged in the business of issuing life insurance' and hence, that petitioner was not a life insurance company within the meaning of section 801." 56 T.C. 497, 507-508.

[405] H.R. Rep. 98-432, part 2, at 1402-1403 (1984); S. Prt. No. 98-169, vol. I, at 525-526 (1984); *see also* H.R. Rep. No. 98-861 at 1043-1044 (1985) (Conference Report).

Description of Proposal

Qualification rules for property and casualty insurance companies

In general

The proposal modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, and to elect to be taxed only on taxable investment income.

Tax-exempt insurance companies

The proposal limits tax-exempt status under section 501(c)(15) to mutual companies, and imposes additional requirements for eligibility. Under the proposal, a property and casualty insurance company is eligible to be exempt from Federal income tax only if (a) it is a domestic mutual company organized in and subject to regulation in a single State, and it writes insurance or reinsurance only on risks located within that State, and (b) its gross income for the taxable year does not exceed $350,000. A foreign company, including one that has made the election to be treated as a domestic company under section 953(d), does not qualify under the proposal. For purposes of the proposal, gross income includes premiums earned, investment income, and other types of gross income. The proposal expands the present-law controlled group rule so that it also takes into account gross income of foreign and tax-exempt corporations, as well as the gross income of any related non-insurance companies. The proposal repeals eligibility for tax-exempt status for stock property and casualty insurance companies.

Election to be taxed only on taxable investment income

The proposal provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (without regard to whether such premiums exceed $350,000) (sec. 831(b)). For purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (including U.S., foreign, and related tax-exempt insurance companies) are taken into account. The proposed changes to the election to be taxed only on taxable investment income apply both to mutual companies and stock companies.

Definition of insurance company

The proposal provides that, for purposes of determining whether a company is a property and casualty insurance company for U.S. tax purposes, the term "insurance company" is defined to mean a company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, the proposal conforms the definition of an insurance company for purposes of the rules taxing property and casualty insurance companies to the rules taxing life insurance companies, so that the definition is uniform, and adopts a stricter and more precise standard than the "primary and predominant business activity" test contained in Treasury Regulations.

The proposed changes to the definition of insurance company apply both to mutual companies and stock companies.

The proposal provides that reporting requirements appropriate to ensure compliance would be promulgated by the Treasury Department.

No inference is intended to be drawn from the proposal as to whether existing companies claiming to be insurance companies eligible for tax-exempt status, or eligible to elect to be taxed only on taxable investment income, are insurance companies for Federal tax purposes under present law.

Effective date

The proposal is effective for taxable years beginning after the date of enactment.

Analysis

Tax-exempt insurance companies

The proposal is directed to abuses of the provision permitting small property and casualty insurers to be tax-exempt that have arisen since the provision was revised in 1986. At that time, the rules generally applicable to insurance companies were updated and streamlined, including a modification extending eligibility for tax-exempt status from mutual companies to mutual and stock property and casualty insurance companies. In conjunction with these changes, the threshold for the provision was modified so that the amount of premiums, rather than the sum of gross investment income and premiums, determined eligibility for tax-exempt status under the provision. Subsequent to these changes, abuses in the area of tax-exempt insurance companies have been publicized. Media attention has focused on the inappropriate use of tax-exempt insurance companies to shelter investment income.[406]

Advocates of reforming the rules for tax-exempt companies assert that use of these organizations as vehicles for sheltering income was never contemplated by Congress. The proliferation of these organizations as a means to avoid tax on income, sometimes on large investment portfolios, is inconsistent with the original narrow scope of the provision, which has been in the tax law for decades. They argue that it is necessary to limit the availability of tax-exempt status under the provision so that it cannot be abused as a tax shelter.[407] As a corollary, they argue that conforming the definition of an insurance company under the property and casualty insurance company rules to the life insurance company rules would serve to improve compliance and facilitate enforcement.

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[406] See David Cay Johnston, *Insurance Loophole Helps Rich,* N.Y. Times, April 1, 2003; David Cay Johnston, *Tiny Insurers Face Scrutiny as Tax Shields,* N.Y. Times, April 4, 2003, at C1; Janet Novack, *Are You a Chump?,* Forbes, Mar. 5, 2001.

[407] Several recent bills include a similar provision that applies a gross receipts test and requires that premiums received for the taxable year be greater than 50 percent of gross receipts in order for a property and casualty insurance company to be eligible for tax-exempt status. *See* sections 493 and 494 of S. 1637, the "Jumpstart our Business Strength (JOBS) Act, S. Rep No. 108-192, 214-217; and sections 3028 and 3029 of H.R. 2896, the "American Jobs Creation Act of 2003," H.R. Rep No. 108-393, 214-218.

Some may argue, however, that the IRS has the authority under present law to prevent abuse of the rule permitting tax-exempt status. They may argue that the definition of an insurance company applicable under Treasury regulations to property and casualty insurance companies permits the IRS to deny or rescind tax-exempt status of an entity with very high investment income in relation to premium income if that entity's insurance activities are not sufficient for it to be treated as an insurance company.

In response, it could be said that the legislative proposal specifically provides that no inference is intended as to whether such companies could be insurance companies under the present-law rules, but that a clarification would be appropriate in light of the abuses that have proliferated.

The proposal eliminates the exemption from income tax for property and casualty insurance companies organized as stock companies, retaining it only for mutual companies in limited circumstances. Advocates of this approach may argue that it returns to the origins of the provision as a rule of administrative convenience for very small local mutual farm insurers. They may argue that reports of abuse of the provision through sheltering investment income seem primarily to involve stock companies, perhaps because the legal structure of mutual companies is more restrictive. It is argued that limiting tax-exempt status to mutual companies, combined with the other requirements of the proposal, narrows eligibility for tax exemption so substantially that the potential for abuse of the provision would be remote. Others, however, might argue that stock companies and mutual companies should be treated equally for this purpose, and that the rationale for imposing additional restrictions on tax-exempt mutual companies applies equally to stock companies. By the same token, if tax-exempt status is repealed for stock companies, it should be repealed for mutual companies as well. In either case, proponents of the view that mutual and stock companies should be treated equally might argue that distinguishing between mutual and stock companies for this purpose is contrary to the policies of the past 20 years, which generally have attempted to treat the two types of companies similarly for most Federal income tax purposes. Some might also note that the proposed changes to eligibility to make the election to be taxed only on taxable investment income, discussed below, apply equally both to mutual and stock companies.

Some might argue that whether the insurance company is organized and regulated only in one State does not directly relate to its ability to avoid tax on investment income. States differ somewhat in their regulatory standards. While a one-State company may be somewhat more likely to be a small local insurer, no such limitation is directly imposed. Advocates of the proposal might counter that the proposal requires the company not only to be organized and regulated within one State, but also to be a domestic mutual company (not a foreign one electing to be treated as domestic), which should serve to limit opportunities for abuse that take advantage of offshore vehicles and foreign regulatory regimes that are more lenient than State regulation.

The proposal uses gross income rather than gross receipts as the determinant for eligibility for tax-exempt status. Depending upon how the gross income test is interpreted or implemented, it could be argued that companies might attempt to manipulate the $350,000 gross income test (perhaps by using losses from other trades or businesses to reduce total gross income below $350,000) in order to avail themselves of the exemption from income tax. Thus, it is

argued, a gross income test could effectively permit the abuse at which the proposal is aimed: exclusion of investment income by companies that cannot truly be considered insurance companies. In response, others may argue that there is no need to base the $350,000 test on premiums or insurance activity, because this is addressed by the proposal's change to the definition of insurance company, which requires that more than half of the company's income be derived from insurance or annuity contracts. It could also be argued that the potential for manipulation could be addressed by appropriate modifications to the proposed gross income test, for example, to exclude losses from the calculation.

Election to be taxed only on taxable investment income

The proposal modifies the requirements for making the election to be taxed only on net investment income by extending the election to companies with annual premiums of $350,000 or less. This proposal might be viewed as simplifying the rules regarding the election by eliminating the minimum premium threshold requirement. Advocates might also argue that the proposal enhances the fairness of the tax law by treating all small property and casualty insurance companies (defined as those with premiums that do not exceed $1.2 million) equally for this purpose. Further, it can be argued that eliminating the $350,000 threshold makes sense because it is based on premiums, whereas the proposal modifying eligibility for exempt status would be based on a different measure, gross income (not premiums as under present law). The exemption and election provisions would no longer mesh seamlessly as under present law, so it is argued that, for fairness and simplicity of the tax law, the lower threshold for the election should be eliminated.

Others might argue that the smallest insurance companies do not need the benefit of this election, because they generally are eligible for tax-exemption under section 501(c)(15). Further, it could be argued that there is nothing complicated about the present-law requirement that companies have premiums that fit within a specified range in order to utilize this election. Also, some might argue that retaining the $350,000 lower threshold for the election makes sense because it limits the investment income election to only those companies that have a minimum level of insurance activity. Thus, companies could not make the election if they have only minimal amounts of insurance activity (even though such amounts comprise more than half of their overall activity).

The proposal treats stock companies and mutual companies equally for this purpose. Some might argue that the rationale for limiting eligibility for tax exemption to mutual companies also applies for purposes of the election to be taxed only on taxable investment income, and that the proposal is internally inconsistent in this regard. Proponents of this view might note that one of the stated reasons for eliminating the exemption from income tax for stock companies, i.e., initial legislative intent which limited the tax benefit to mutual companies, would also justify limiting the election only to mutual companies. Others might argue that the primary abuse being addressed by these proposals is the avoidance of tax on investment income, and that there is no potential for such abuse by a company (whether a stock company or a mutual company) that elects to pay tax on its investment income. Thus, the election should be available to both stock and mutual companies.

Definition of insurance company

Advocates of conforming the definition of an insurance company so that it is consistent for property and casualty insurance companies and life insurance companies argue that consistency in the definition would improve administration and enforcement of the law and reduce the likelihood of disputes and litigation over the meaning of an insurance company. It is further argued that the definition currently used under the life insurance company rules is quantifiable, unambiguous, and preferable to the vaguer rule that applies to property and casualty insurers under Treasury regulations. It is argued that a clear, enforceable definition would benefit both taxpayers and the government. In particular, it would facilitate identification of those companies entitled to tax exempt status and provide a straightforward test for distinguishing those that are not eligible.

Opponents of the proposal relating to the definition of a life insurance company might argue that a definition applicable to property and casualty insurers already exists in the law (albeit in regulations), and that changing it is not necessary or does not clarify the law significantly. They might argue that the regulatory definition is sufficiently similar to the statutory definition that would be applied under the proposal to property and casualty insurers that little simplification or additional clarity is provided. Nevertheless, on the other hand, advocates of the proposal may argue that a uniform definition serves to eliminate questions of interpretation and improves the predictability of the result under the law in any particular case.

Prior Action

A similar provision was included in President Clinton's fiscal year 2001 budget proposals. That proposal would modify the eligibility requirement for tax-exempt status for an insurance company so the $350,000 threshold would be based on gross receipts rather than premiums, and would limit eligibility to domestic companies. That proposal (like the current proposal) would also eliminate the lower dollar threshold for eligibility to elect to be taxed only on taxable investment income.

Several recent bills include a similar provision that applies a gross receipts test and requires that premiums received for the taxable year be greater than 50 percent of gross receipts in order for a property and casualty insurance company to be eligible for tax-exempt status. The bills generally provide for conforming the definition of an insurance company so that it is consistent for property and casualty insurance companies and life insurance companies.[408]

[408] *See* sections 493 and 494 of S. 1637, the "Jumpstart our Business Strength (JOBS) Act, S. Rep No. 108-192, 214-217; and sections 3028 and 3029 of H.R. 2896, the "American Jobs Creation Act of 2003," H.R. Rep No. 108-393, 214-218.

D. Increase Penalties for False or Fraudulent Statements Made to Promote Abusive Tax Shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[409] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Description of Proposal

The proposal modifies the penalty amount to equal 50 percent of the income derived by the person from the activity for which the penalty is imposed. The enhanced penalty does not apply to valuation overstatements.

Effective date.–The proposal is effective for activities after the date of enactment.

Analysis

See the general discussion in section V.A. following the description of the proposals to combat tax avoidance transactions.

Prior Action

Several legislative proposals have included this proposal.[410]

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[409] Sec. 6700.

[410] *See*, e.g., Joint Committee on Taxation, *Description of the "Highway Reauthorization and Excise Tax Simplification Act of 2004"* (JCX-5-04), January 29, 2004; House Ways and Means Committee Report of H.R. 2896, *American Jobs Creation Act of 2003*, (H. Rep. 108-393, November 21, 2003); Senate Finance Committee Report of S. 1637, *Jumpstart our Business Strength (JOBS) Act*, (S. Rep. 108-192, November 7, 2003).

E. Modify Charitable Contribution Rules for Donations of Patents and Other Intellectual Property

Present Law

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.[411] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to reduce the deduction amount by any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property. Under present law, certain copyrights are not considered capital assets, in which case the charitable deduction for such copyrights generally is limited to the taxpayer's basis.[412]

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[413] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[414] In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[415]

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[411] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[412] *See* sec. 1221(a)(3), 1231(b)(1)(C).

[413] Sec. 170(f)(3).

[414] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

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

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[416] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[417] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[418]

Description of Proposal

The proposal provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the donated property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in subsequent taxable years based on the amount of the royalties or other revenue actually received by the charitable donee from the donated property. For this purpose, "other revenue" includes sales proceeds and net income derived by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used). The amount of the additional charitable deduction is calculated as a sliding-scale percentage of revenues actually received by the charitable donee from the donated property during the taxable year of the charitable donee.

Table 11, below, summarizes the amount of charitable deduction the taxpayer may claim in the year of contribution and each year thereafter.

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[416] P.L. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under P.L. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[417] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[418] Treas. Reg. sec. 1.170A-13(c)(3).

Table 11.–Charitable Deduction for Contribution of a Patent or Other Intellectual Property

Taxable Year	Deduction Permitted for Such Taxable Year
Year of Contribution	Basis plus 100 percent of revenue received by charity during the taxable year
1st year after contribution	100 percent of revenue
2nd year after contribution	90 percent of revenue
3rd year after contribution	80 percent of revenue
4th year after contribution	70 percent of revenue
5th year after contribution	60 percent of revenue
6th year after contribution	50 percent of revenue
7th year after contribution	40 percent of revenue
8th year after contribution	30 percent of revenue
9th year after contribution	20 percent of revenue
10th year after contribution	10 percent of revenue
Taxable years thereafter	No deduction permitted

No charitable deduction is permitted with respect to any revenues received by the charitable donee after the expiration of the patent or intellectual property, or after the tenth anniversary of the date the contribution was made by the donor.

The taxpayer is required to obtain written substantiation from the donee of the amount of any revenue received from (and properly allocable to) the donated property during the charity's taxable year. In instances where the donor's taxable year differs from the donee's taxable year, the donor bases its charitable deduction on the revenues received by the charitable donee during the donee's taxable year that ends within the donor's taxable year.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003.

Analysis

The valuation of charitable contributions of patents and similar intellectual property recently has become a concern. Although methodologies exist to appraise intellectual property, the actual value of intellectual property is by its very nature speculative and dependent on a number of future events, such as, in the gift context, whether the charity makes the appropriate investments, has the right personnel and equipment, and has the necessary sustained interest fully to develop the property. Many gifts are of intellectual property for which there is no sales market, which compounds valuation difficulties because an appraiser cannot rely on what a reasonable buyer would pay for the property pursuant to arm's length negotiations. As a result, the high values often claimed for contributions of intellectual property result in a significant tax benefit to the donor, but little or no actual benefit to the charity, as many patents or other properties later turn out to be worthless, or produce far less revenue than projected in valuations performed by or on behalf of the donor. Because the charitable contribution deduction depends on the value of the property at the time of the gift, the IRS faces significant obstacles in challenging intellectual property valuations, which may appear to be reasonable, even though later events prove otherwise, and which require considerable expertise to evaluate properly.

The President's proposal, along with recent Congressional proposals, address the difficulties of valuing intellectual property in the context of charitable giving by eliminating the reliance on valuations of the donated property. Under the President's proposal, a taxpayer generally would receive a deduction of basis at the time of the contribution and have a right to receive future charitable contribution deductions based on the actual revenue generated by the property contributed. Similarly, a recent Senate proposal also provides that taxpayers generally will receive a basis deduction upon contribution, with a right to receive future payments from the charity based on the charity's income from the contributed property. Both approaches attempt to provide a more accurate measure of the value of intellectual property by looking at results instead of predictions.[419]

Critics of either approach might argue that taxpayers will no longer give intellectual property to charity because a basis deduction plus the promise of future economic benefits does not provide enough up-front incentive for taxpayers to review their portfolios of intellectual property, decide which are most appropriate for gift (rather than for sale, joint-venture, or abandonment), and find a suitable donee. Such critics might acknowledge that the present law system needs reform, but would argue that a better approach is to strengthen appraisal standards and limit the class of charitable donees who would be eligible to receive charitable contributions of intellectual property (for example, educational and research organizations). Such critics might also emphasize that a taxpayer's basis in intellectual property(and thus the upfront charitable deduction) may be zero or minimal because taxpayers often deduct the costs associated with developing intellectual property as ordinary and necessary business expenses, or as research and development expenses.

[419] Modifications to reporting rules may be needed to avoid requiring appraisals for intellectual property when a basis deduction is claimed.

A response to such criticism is that a "strengthened appraisal" regime does not go far enough to address the underlying problem. Even under tighter appraisal rules, the appraisal still would determine the amount of the deduction and both donors and appraisers, however well-intentioned, would have the same incentives as exist under present law to overstate the worth of the property. Given the inherent difficulties of valuing intellectual property (and reviewing such valuations), some would argue that it is not realistic to expect that improved valuation standards substantially would improve the process. In addition, one reason advanced for strengthened appraisal rules as an alternative to the proposal is the need to retain a significant incentive for intellectual property donations. However, even assuming that a strengthened appraisal regime could work as intended, for example, by ensuring that relevant factors always are taken into account (such as the stage of development of the property, future efforts and investments by the donee, and the capabilities of the donee, among others), such a regime would not provide the desired incentive because many properties that presently receive high valuations would receive significantly lower valuations. Thus, it may be argued that reform of the valuation process and retention of a significant up-front financial benefit for properties with questionable income potential are mutually exclusive objectives.

In addition, a "strengthened appraisal" approach does nothing to equalize the respective positions of the taxpayer and the IRS for purposes of administering the tax laws regarding charitable donations of property with highly subjective values. Under the strengthened appraisal approach, the IRS remains at a substantial disadvantage because it cannot review an appraisal of the property until it conducts an examination, which generally results in a costly appraisal expense to determine a value of highly subjective property as of a prior date. Proponents of the strengthened appraisal regime might respond that taxpayers could pay a fee for a review appraisal by the IRS prior to the gift; however, even assuming that the IRS could efficiently and accurately review appraisals (or perform their own appraisals) prior to gifts of intellectual property, the value of the property contributed would remain highly speculative and significant disputes between the taxpayer and the IRS could undermine any incentive effect. In short, some argue that any deduction for intellectual property based on an appraised fair market value is inadministrable (both in terms of efficiency and proper measurement of income) because the values of intellectual property are too speculative.

Some also argue that a fair market value deduction permits taxpayers a double-benefit because taxpayers already have received tax benefits in the form of business expense and research and development deductions, which accounts for taxpayers' low basis in intellectual property, and possibly a research tax credit. Others argue that this double benefit exists for charitable contributions of appreciated property generally and that the proposal unfairly treats intellectual property relative to other types of property by jeopardizing the double benefit.

Many proponents of a basis deduction coupled with the potential for future economic benefits (the "future benefits approach") argue that eliminating the reliance on valuations of difficult-to-value property takes away the ability and incentive of taxpayers to, intentionally or otherwise, inflate the value of contributed intellectual property. Congress has determined in other areas where valuation is especially problematic -- charitable contributions of property created by the personal efforts of the taxpayer and charitable contributions to certain private foundations -- that a basis deduction generally is the correct result. By providing more than a basis deduction, a future benefits approach provides an incentive to donate intellectual property.

If and when the property demonstrates its economic potential, the donor reaps the benefit -- either in the form of a revenue stream or additional deductions. Although critics might respond that such a benefit, unlike the present law deduction, will not help finance donor's efforts to transfer to the marketplace intellectual property that does not fit within the donor's core business, it can be argued that donors have sufficient economic incentive to undertake such activity even without any charitable deduction. Donation is merely one of several options for a holder of intellectual property; certain of the other existing options, for example, sale or joint-venture, provide an arguably greater economic incentive than donation for taxpayer's to mine their intellectual property portfolios to determine the best use of non-core intellectual property.

The President's proposal and the recent Senate proposal are similar conceptually but differ in terms of the future benefit provided to the donor. The President's proposal provides the donor future charitable deductions based on revenues received by the charity (including any sales proceeds) that are properly allocable to the contributed intellectual property. The future charitable deductions are a sliding-scale percentage of the revenue received, with a higher percentage in the years closer in time to the contribution. No future benefit inures to the donor beyond ten years (or the expiration of the property) from the contribution date. The recent Senate proposal provides for future payments from the charity to the donor, up to 50 percent of the payments received by the charity (the percentage is negotiated by the charity and the donor prior to contribution). Payments may be made up to the earlier of the legal life of the property or twenty years from the contribution date, though the donor may not share in any sales proceeds. The Senate proposal also provides that the donor may receive revenues, in a manner determined by the Secretary of the Treasury, for contributed property used by the charity in a manner that does not generate revenue.

One salient difference between the Administration and Senate proposals is who bears the cost of the future economic benefit provided to the donor if the property generates future income.[420] Under the President's proposal, the cost is borne by the Federal government in the form of a future tax deduction. Under the Senate proposal, the cost is borne by the charity, which pays out a percentage of revenue received to the donor. The future benefit provided under the President's proposal generally is of shorter duration (maximum 10 versus 20 years, but in neither case beyond the legal life of the property). Arguably, the shorter time period of the President's proposal is more appropriate because the further in time from the date of the gift, the more likely that the value that inures to the charity from its use of the property is attributable to value added to the property by the charity since the time of the contribution. The President's proposal permits donors to derive a benefit from the sale of the contributed property; whereas the Senate proposal does not. To the extent a sale occurs close in time to the contribution, the sale may approximate the value of the property at the time of contribution and the donor arguably should share in the proceeds. However, if a sale occurs many years subsequent to the contribution, the donor arguably should not benefit from the sale because the value at such time is more likely to be due to the charity's investment in the property.

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[420] If the donated property does not generate future income, the effects of the President's proposal and the Senate proposal on the donor, donee, and the fisc should be the same (i.e., a charitable deduction equal to the lesser of basis or fair market value with no future income derived by the charity).

The President's proposal addresses this concern generally by decreasing the benefit available to the donor over time. The President's proposal does not address how to permit donors to benefit from property that is used by the charity but that does not generate income. The Senate proposal permits such a benefit, but leaves the manner of determining the benefit to the Secretary of the Treasury. Arguably, such a benefit should be provided.

Both proposals require that the donor completely relinquish ownership of the contributed property; however both proposals appear to encourage the commercialization of intellectual property, which some might argue is inconsistent with a charity's general mission to further exempt, not commercial, purposes.

The sliding scale percentage method proposed by the Administration (allowing 100 percent of revenue in year one, reduced to 10 percent in year 10 and zero thereafter) might be viewed as inordinately benefiting donors for revenues received in the early years, and inordinately penalizing donors for revenues received in the later years. This effect may be compounded by the fact that tax benefits in later years generally are worth less than tax benefits in earlier years, because of the time value of money.[421] For example, assume a $100 payment is received by the donee in a single year during the 10-year period (with no other payments received with respect to the donated property), a 35 percent income tax rate for the donor, and an annual discount rate of five percent. A $100 payment received in year one by the donee would entitle the donor to a tax benefit with a present value of $33.30 ($100 payment times 100 percent allowed deduction, times 0.951 discount factor; see Table 12, below). The same $100 payment received in year 10 by the donee would entitle the donor to a tax benefit with a present value of $2.13 ($100 times 10 percent allowed deduction, times 0.609 discount factor; see chart below).[422] Table 12, shows the effect of the proposed sliding scale reduction and the time value of money, using the assumptions of a five percent discount rate, a 35 percent tax rate, and an annual payment of $100.

[421] Of course, this assumes that the tax benefit may be used in the relevant years.

[422] The disparity is less for lower discount rates, and more for higher discount rates.

Table 12.–Present Value of Tax Benefit from a Contribution of Intellectual Property

Year of Payment	Payment Amount	Sliding Scale Percentage	Tax Benefit	Present Value of Tax Benefit
1	$100	$100	$35.00	$33.30
2	100	90	31.50	28.51
3	100	80	28.00	24.11
4	100	70	24.50	20.07
5	100	60	21.00	16.36
6	100	50	17.50	12.97
7	100	40	14.00	9.87
8	100	30	10.50	7.04
9	100	20	7.00	4.47
10	100	10	3.50	2.13
Thereafter	100	0	0	0
Total present value of tax benefit				$158.83

If desired, much of this disparity could be reduced by reducing the range of the sliding scale percentages (e.g., 67 percent allowed deduction in years one through five, 33 percent allowed deduction in years six through 10), or by employing a constant allowance percentage (e.g., 50 percent for each year of the 10 year period). For example, assuming the same five percent discount rate and a 35 percent tax rate, a constant deduction allowance percentage of 59 percent would yield approximately the same present value (after-tax) as a 10 year stream of equivalent payments under the President's sliding scale proposal.

Under the recent Senate proposals, the disparity between the present value of a payment received in year one versus year 10 would be limited to the discount factor element, because the donor would be entitled to receive the same payment percentage in each year throughout the permitted payment period.

Prior Action

H.R. 2, the "Jobs and Growth Tax Act of 2003," as passed by the Senate on May 15, 2003, contained a provision that generally provided a basis deduction for charitable contributions of patents and other intellectual property. This provision was struck in conference.

S. 1637, the "Jumpstart Our Business Strength Act," as reported by the Senate Committee on Finance on October 1, 2003, contained a similar provision, except that the future benefits provided to the donor of intellectual property is in the form of payments by the charitable donee.

F. Require Qualified Appraisals for Charitable Contributions of Vehicles

Present Law

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.[423] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

For certain contributions of property, the taxpayer is required to determine the deductible amount by subtracting any gain from fair market value, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date; (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of capital gain property generally are deductible at fair market value. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

A taxpayer who donates a used automobile to a charitable donee generally deducts the fair market value (rather than the taxpayer's basis) of the automobile. A taxpayer who donates a used automobile generally is permitted to use an established used car pricing guide to determine the fair market value of the automobile, but only if the guide lists a sales price for an automobile of the same make, model and year, sold in the same area, and in the same condition as the donated automobile. Similar rules apply to contributions of other types of vehicles and property, such as motorized boats.

Charities are required to provide donors with written substantiation of donations of $250 or more. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.[424] Under

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[423] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[424] P.L. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds

Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[425] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number ("TIN") of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[426]

Appraisal fees paid by an individual to determine the fair market value of donated property are deductible as miscellaneous expenses subject to the 2 percent of adjusted gross income limit.[427]

Description of Proposal

The proposal generally allows a charitable deduction for contributions of vehicles only if the taxpayer obtains a qualified appraisal of the vehicle. The proposal applies to automobiles and other types of self-propelled motorized vehicles or modes of transportation, including, for example, boats and motorcycles. The proposal does not affect contributions of inventory property. The definition of qualified appraisal generally follows the definition contained in present law, although the appraisal of a donated vehicle must be obtained by the taxpayer by the time the contribution is made.

Under the proposal, the Secretary may establish an administrative safe harbor in published guidance. For example, such guidance might provide that a qualified appraisal is required only for contributions of vehicles that are subject to generally applicable written substantiation requirements under present law (i.e., contributions for which deductions in excess of $250 are taken by the taxpayer), or provide an alternative standard for what constitutes a qualified appraisal in certain cases.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003.

$5,000). Under P.L. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[425] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[426] Treas. Reg. sec. 1.170A-13(c)(3).

[427] Rev. Rul. 67-461, 1967-2 C.B. 125.

Analysis

In recent years, charities and their agents have actively solicited donations of used automobiles. The General Accounting Office recently estimated that approximately 4,300 charities (or 2.7 percent of charities with revenues of $100,000 or more) have vehicle donation programs.[428] In many cases, the vehicles are not used by the charitable donee for a charitable purpose, but are sold shortly after the donation. Although some charities use the automobiles to further their charitable purposes, e.g., to transport employees, volunteers, or charitable beneficiaries in the course of conducting the organization's exempt activities, such use is in the minority.

The General Accounting Office estimated that approximately 0.6 percent of individual tax returns, or 733,000 returns, contained tax deductions for vehicle donations for the 2000 taxable year.[429] Although the General Accounting Office could not verify the accuracy of taxpayer claims regarding the value of their donated vehicle,[430] many are concerned that the amounts of charitable deductions claimed by taxpayers often substantially exceed the fair market values of the donated vehicles because taxpayers often use published values for cars that are in better condition than the donated vehicles.[431] Further, donated automobiles oftentimes are sold at auction for wholesale or liquidation prices or to salvage yards for scrap prices, so that the amount of the claimed charitable deduction substantially exceeds the net sales proceeds (gross sales proceeds less fees, commissions, towing, advertising, program administration, or other vehicle processing and other transaction costs paid to agents) received by the charity.[432]

For two-thirds of the 54 specific vehicle donations GAO examined in its report, charities received five percent or less of the value donors claimed as deductions on their tax returns.[433] In some cases, the charity incurred transaction costs that exceeded the vehicle gross sales price, so that the charity actually may have lost money as a result of the donation and subsequent sale of the vehicle.[434]

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[428] United States General Accounting Office, Report to the Committee on Finance, U.S. Senate, *Vehicle Donations, Benefits to Charities and Donors, but Limited Program Oversight*, GAO-04-73 (November 2003), p. 7.

[429] *Id*. at 8.

[430] *Id*. at 15.

[431] *Id*. at 19 ("Charities stated that a number of the vehicles donated are sold for scrap, and some said donor claims about vehicle value might be inflated.").

[432] *Id*. at 2.

[433] *Id.* at Highlights.

[434] *Id*. at p. 17 and at Table 4, p. 37.

The following table summarizes the aggregate information contained in the GAO report with respect to the 54 vehicles tracked by the GAO from donation to the taxpayer's claim for a charitable deduction.[435]

Vehicle gross sales price (dollars)	**Net proceeds (loss) to charity from vehicle sale (dollars)**	**Donated vehicle value claimed on tax return (dollars)**	**Gross sale price as percent of amount donor claimed**	**Proceeds to charity as a percent of gross sale price (loss)**	**Charity receipt (loss) as percent of donor claim**
17,205	9,970	129,656	13.3%	57.9%	7.7%

It is noted that with respect to the GAO table from which this summary information is obtained, the GAO stated: "Information on this judgmental set of 54 vehicle donations were obtained from 4 charities in 4 states. The individual cases or cases in aggregate are for illustration only, and cannot be used to generalize vehicle donations overall."[436]

Based on the GAO study of these specific 54 vehicles, the net proceeds received by the charities with respect to the vehicles was less than eight percent of the amount claimed by the donors as charitable deductions for the vehicle donations. The vehicles were sold for an aggregate selling price of approximately 13 percent of the aggregate charitable deductions claimed for the vehicles. The charities received proceeds of approximately 58 percent of the gross sales proceeds for the 54 vehicles. The average (mean) charitable deduction for each of the vehicles in the study was $2,401, and the average (mean) gross sales price for each of the vehicles was $319, with the charity receiving average net proceeds of $185 per vehicle.

The GAO reported that proceeds from vehicle donation sales were not a crucial source of income for the majority of the charities it reviewed.[437] From the perspective of the charitable donee, there arguably is little incentive to maximize the selling price of a donated vehicle, because the charity frequently receives net cash proceeds it would not otherwise receive, with little effort expended by it. It generally is easier for a charity to have an agent sell the donated vehicles at auction, even at prices substantially less than at retail price, than it is to hold the vehicle to extract the maximum selling price.

The proposal attempts to address the overvaluation problem by requiring that a taxpayer obtain a qualified appraisal by an independent and competent appraiser in order to claim a charitable deduction for a donated automobile or other vehicle. A qualified appraisal prepared by an independent and competent appraiser would provide an appraised value that takes into account geographic markets and the condition of the specific vehicle being donated by the

[435] *Id.* at Table 4, p. 37. The following table was prepared by the staff of the Joint Committee on Taxation, based on data contained in the GAO table.

[436] *Id.* at p. 37.

[437] *Id.* at 15.

taxpayer, at the time the vehicle is being donated.[438] This is intended to have the effect of reducing the number and extent of overvaluations of vehicles that are being donated to charities. However, some might argue that the Treasury proposal does not go far enough to address the overvaluation problem associated with donated vehicles, pointing out the administrative difficulties the IRS faces in examining and enforcing charitable deductions with respect to in kind property in general, and claiming that it will only be a matter of time before an appraisal industry emerges to provide qualified appraisals to maximize the value to be claimed by automobile donors. Others might also argue that even if the valuation of vehicles is improved, auction sales of vehicles generally will continue and would still result in sales prices significantly lower than appraised prices.

Other possible alternatives to address the overvaluation problem include limiting the charitable deduction for a vehicle donation to the actual selling price (gross sales price could be used for this purpose) derived from the sale of the donated vehicle. Limiting the charitable deduction to the price at which the donated vehicle was sold would provide an easily determinable measure of value for purposes of the charitable deduction. In order for a selling price proposal to be administrable, however, it likely would have to defer the claiming of a charitable deduction until the charity reports the sales price to the donor, which could be in a taxable year after the contribution had been made.[439] A selling price deduction rule would impose some administrative burdens on the charitable donees, and the donor would not have the certainty of knowing how much the contribution deduction is worth at the time he or she makes the contribution, which could decrease the incentive to make contributions of automobiles and other vehicles. Critics of a "selling price" rule also may argue that it is unfair for donors to have to tie their deduction amount to the selling price, especially in those cases where the vehicle is sold at auction, because the price at which the charity sells the donated vehicle is beyond the control of the donor and may not approximate fair market value. Others may counter that the "selling price" rule is an appropriate proxy for fair market value, and that such a rule would provide an incentive for a donor to attempt to determine both the value of the vehicle and the methods used by the donee to maximize net proceeds it derives from vehicle sales fundraisers. To the extent that charities do not use the vehicles in their exempt purposes, do not rely on vehicle donation programs as a significant source of revenue, and consistently sell donated vehicles at wholesale or scrap auction prices, some would argue that a "selling price" rule that discourages large numbers of automobile donations is a worthy goal. In addition, under a "selling price" rule, an exception could be made for vehicle donations if the charity uses the vehicle in its exempt programs.

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[438] The proposal provides an exception from the appraisal requirement for inventory property contributed by a taxpayer. In such cases, the taxpayer generally is in a reasonable position to know the condition and fair market value of the donated property, and imposing a separate appraisal requirement arguably would add unnecessary transaction costs to such donations.

[439] A variation of this alternative might be to permit the donor to take a charitable deduction for either the selling price as reported by the charity to the donor, or a legally enforceable option price that a dealer in used cars is willing to pay the donor for the specific vehicle.

Prior Action

No prior action.

G. Reform the Tax Treatment of Leasing Transactions with Tax-Indifferent Parties

Present Law

Overview of depreciation

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods based on such property's class life. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years and are significantly shorter than the property's class life which is intended to approximate the economic useful life of the property. In addition, the depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Characterization of leases for tax purposes

In general, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

A sale-leaseback transaction is respected for Federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[440]

Recovery period for tax-exempt use property

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[441] For purposes of this rule, "tax-exempt use property" is tangible property that is leased (other than under a short-term lease) to a tax-exempt entity.[442] For this purpose, the term "tax-

[440] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

[441] Sec. 168(g)(3)(A). Under present law, section 168(g)(3)(C) states that the recovery period of "qualified technological equipment" is five years.

[442] Sec. 168(h)(1).

exempt entity" includes Federal, State and local governmental units, charities, and, foreign entities or persons.[443]

In determining the length of the lease term for purposes of the 125-percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.[444] In addition, property is not treated as tax-exempt use property merely by reason of a short-term lease. In general, a short-term lease means any lease the term of which is less than three years and less than the greater of one year or 30 percent of the property's class life.[445] Also, tax-exempt use property generally does not include any qualified technological equipment if the lease to the tax-exempt entity has a lease term of five years or less.[446] The term "qualified technological equipment" is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment.[447] Finally, tax-exempt use property does not include computer software because it is intangible property.

Description of Proposal

Overview

The Administration's proposal modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt

[443] Sec. 168(h)(2).

[444] Sec. 7701(e) provides that a service contract will not be respected, and instead will be treated as a lease of property, if such contract is properly treated as a lease taking into account all relevant factors. The relevant factors include, among others, the service recipient controls the property, the service recipient is in physical possession of the property, the service provider does not bear significant risk of diminished receipts or increased costs if there is nonperformance, the property is not used to concurrently provide services to other entities, and the contract price does not substantially exceed the rental value of the property.

[445] Sec. 168(h)(1)(C).

[446] Sec. 168(h)(3). However, the exception does not apply if part or all of the qualified technological equipment is financed by a tax-exempt obligation, is sold by the tax-exempt entity (or related party) and leased back to the tax-exempt entity (or related party), or the tax-exempt entity is the United States or any agency or instrumentality of the United States.

[447] Sec. 168(i)(2).

entity, and establishes rules to limit deductions associated with leases to tax-exempt entities unless such lease satisfies specified criteria.

Modify the recovery period of certain property leased to a tax-exempt entity

The proposal modifies the recovery period for qualified technological equipment and computer software leased to a tax-exempt entity[448] to be the longer of the property's assigned class life or 125 percent of the lease term. The proposal does not apply to short-term leases as defined under present law section 168(h)(1)(C) and section 168(h)(3).

Modify definition of lease term

In determining the length of the lease term for purposes of the 125-percent calculation, the proposal requires that the lease term include all service contracts and other similar arrangements following a lease of property to a tax-exempt party. This requirement applies to all leases of property to a tax-exempt entity.

Limit deductions for leases of property to tax-exempt parties

The proposal also provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions from each lease transaction in excess of the taxpayer's gross income from the lease for that taxable year. This limit applies to deductions or losses related to a lease to a tax-exempt party and the leased property. Any disallowed deductions are carried forward and treated as deductions related to the lease in the next taxable year subject to the same limitations. A taxpayer is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt party is not subject to the deduction limitations described in the preceding paragraph if the lease satisfies all of the following five requirements.

(1) Property is not financed with tax-exempt bonds

The leased property is not financed with tax-exempt bonds. For example, a lease of rolling stock to a municipality would be subject to the proposal if the proceeds of the municipality's general obligation bond were used to finance the acquisition of the rolling stock (in whole or part).

(2) Tax-exempt entity does not monetize its lease obligation

The tax-exempt party does not enter into an arrangement to monetize its lease obligations, including any purchase option, in an amount that exceeds 20 percent of the taxpayer's cost of the leased property. Arrangements to monetize lease obligations include a defeasance arrangement, a loan by the tax-exempt party (or an affiliate) to the taxpayer (or an affiliate), a deposit agreement, a letter of credit collateralized with cash or cash equivalents, a

[448] The proposal defines a tax-exempt entity as under present law. Thus, it includes Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

payment undertaking agreement, a lease prepayment, a sinking fund arrangement, any similar arrangement, and any other arrangement identified by the Secretary in regulations. The Secretary is authorized to promulgate regulations providing that this requirement is satisfied even if a tax-exempt party provides cash-equivalent credit support in excess of 20 percent of the taxpayer's cost of the leased property if the creditworthiness of the tax-exempt party would not otherwise satisfy the lessor's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's cost of the property. In addition, on the purchase option exercise date, if any, such credit support would not be permitted to exceed 50 percent of the lessee's purchase option price.

(3) Lessor maintains a substantial equity investment in property

The lessor must make and maintain a substantial equity investment in the leased property. For this purpose, a lessor would not have made or maintained a substantial equity investment unless the lessor makes an unconditional initial equity investment in the property of at least 20 percent of the cost of the leased property and such equity investment continues throughout the lease term.

(4) Tax-exempt entity does not retain more than minimal risk of loss

The tax-exempt party must not assume or retain more than a minimal risk of loss (other than the obligation to pay rent and insurance premiums, to maintain the property or other similar conventional obligations of a net lease) through a put option, a residual value guarantee, residual value insurance, any similar agreement (such as a service contract), or any other arrangement identified by the Secretary in regulations. For this purpose, a tax-exempt party would have assumed or retained more than a minimal risk of loss if: (1) as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt party, the taxpayer is insulated from any portion of the loss that would occur if the value of the leased property were 25 percent less than the leased property's projected fair market value at lease termination; (2) as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt party, the taxpayer is insulated from a risk of loss in the aggregate that is greater than 50 percent of the loss that would occur if the value of the leased property were zero at lease termination; or (3) the tax-exempt party assumes or retains a risk of loss described by the Secretary in regulations.

(5) Secretary does not otherwise describe the lease

The Secretary in regulations does not otherwise describe the lease.

Effective date.–The proposal is effective for leases entered into after December 31, 2003. No inference should be drawn regarding the appropriate tax treatment of similar transactions entered into prior to January 1, 2004.

Analysis

Complexity issues

Under the proposal, taxpayers would be required to perform additional analysis with respect to leasing transactions with tax-exempt entities. For leases subject to the proposal, businesses would have to perform additional computations and keep additional records. In addition, regulatory guidance likely would be necessary to clarify certain aspects of the proposal. However, it is likely that the proposal will significantly reduce the amount of tax-advantaged leasing to tax exempt entities, thus limiting the number of taxpayers affected by the complexity of the proposal. Additionally, taxpayers engaging in the types of transactions subject to the proposal generally are sophisticated corporate taxpayers with the expertise and resources to comply with the additional requirements.

Policy issues

Background

The recent focus on certain leasing transactions with tax-exempt entities raises a number of significant tax policy issues. The relative importance of these issues varies according to whether the lessee is a Federal agency, a State or local governmental agency, a nonprofit organization, or a foreign government or person. Congress analyzed many of these issues in the early to mid-1980s and enacted significant reforms with respect to the leasing of property by tax-exempt entities. However, taxpayers have been able to structure leasing transactions with tax-exempt entities that circumvent the present-law rules, often through the unanticipated exploitation of certain exceptions to the rules. Before reviewing the specific policy issues of the proposal, it is useful to review some of the general tax policy issues that are relevant to tax-exempt leasing transactions. These tax policy issues were relevant over 20 years ago and remain relevant today to determine the merits of updating and altering the present-law rules to address leasing transactions with tax-exempt entities.

Efficiency.–The first issue is whether leasing arrangements are an efficient way to provide Federal assistance to tax-exempt entities. The dollar value of the tax benefits from such transactions is shared by the tax-exempt entity, the lessor (a taxable entity), and the lawyers, investment bankers, leasing companies, and other agents or investors that are involved in the transaction. Because the benefits to the tax-exempt entity are only a portion of the total benefits derived from the transaction, the cost to the Federal government is greater than the benefits provided to the tax-exempt entity. For example, a review of over 30 transactions approved by the Federal Transit Authority[449] indicated that, on average, fees paid to lawyers, investment bankers, leasing companies, and other agents advising or assisting tax-exempt entities equaled approximately 24 percent of the benefits received by the tax-exempt entities. With respect to the sharing of the benefits between the lessor and a tax-exempt entity, promotional materials describing long-term lease/leaseback arrangements indicate that the tax-exempt entity is entitled

[449] The Federal Transit Authority is an agency within the U. S. Department of Transportation.

to an upfront payment equal to three to four percent of the market value of the property. The lessor's benefit is more complicated, but is generally equal to 35 percent of the market value of the leased property reduced by taxable gain on the sale of the property back to the tax-exempt entity at the end of the lease term. Because the lessor's tax benefit (and subsequent additional taxable income) is recognized over a number of years, the tax benefits (and tax costs) must be discounted (present valued) to accurately compare such benefit to the tax-exempt entity's benefit from the transaction.

To the extent that the significant benefits of the leasing transaction are transferred to taxable entities, corporate taxpayers, and advisors of tax-exempt entities, leasing is an inefficient way of providing assistance to tax-exempt entities. A more efficient and direct approach to assisting tax-exempt entities might include direct spending programs. However, this approach also may incur additional costs that reduce the benefits to the tax-exempt entity (e.g., additional costs to effectuate the program). Alternatively, allowing tax-exempt entities to sell tax benefits (e.g., depreciation) may allow a broader group of tax-exempt entities to benefit. Currently, the benefits generally are limited to tax-exempt entities with significant assets that satisfy certain specific characteristics (e.g., railcars, large number of buses, etc.). This results in a disproportionate portion of the benefits being allocated to a narrow group of tax-exempt entities.[450] Providing a direct ability to transfer the tax benefits would allow other assets, and lower value assets, to qualify that are precluded today because any tax benefits are offset by the significant costs of engaging in these transactions. However, previous proposals that sanctioned the transfer of tax benefits resulted in significant revenue loss and were quickly repealed (e.g., safe harbor leasing). These proposals also resulted in a sharing of benefits between tax-exempt entities, taxable entities, and other parties involved in the transaction.

Budget oversight.–A second issue is the impact of governmental leasing on the budget process. In the case of a lease to a governmental agency, leasing can distort the appropriations process by shifting capital acquisition costs from the agency's budget to the U.S. Treasury in the form of reduced tax revenues. Thus, leasing reduces the oversight over spending normally exercised by the appropriations process by converting direct outlays, which require appropriations, into tax benefits, which do not.

In addition, leasing by Federal, State, and local agencies can distort the actual level of financial support provided to a governmental agency. As mentioned above, these transactions shift costs from agencies' budgets to the U.S. Treasury, making it difficult to determine how much Federal assistance is being provided and to whom or for what purposes it is being provided. For example, a U.S. municipality that leases its subway railcars effectively transfers the local operating costs of its subway system to all taxpayers without regard to use and without any consideration by Congress of whether such cost transfer is appropriate. Removing the tax

[450] For example, eight cities (Atlanta, Chicago, Los Angeles, New York, Newark, Philadelphia, San Francisco, and Washington DC) comprise approximately 75 percent of the lease transactions (by value of assets) reviewed by the Federal Transit Authority since 1988. Further, four of these eight cities (Atlanta, Chicago, New York, Newark) comprise approximately 50 percent of the transactions (by value of assets) reviewed.

incentives for government agencies to lease rather than purchase property reduces distortions in the budget process and enables Congress to more effectively oversee the appropriation of funds.

Public perception.–A third issue relates to whether the use of tax-motivated arrangements by tax-exempt entities creates perceptions that the tax system is unfair or dysfunctional. This possibility seems especially likely when highly visible assets, such as municipal buildings or transportation assets, are offered in sale-leaseback transactions, or when U.S. tax benefits are allowed for assets that are neither produced nor used domestically. With regard to certain cross-border leasing transactions, the U.S. taxpayers essentially are subsidizing the purchase of property for a foreign government or business for which the U.S. taxpayers obtain no benefit.[451]

Neutrality.–A fourth issue is the extent to which the ability of a tax-exempt entity to transfer depreciation and interest expense deductions through a lease with a taxable entity economically distorts the decision of the tax-exempt entity between purchasing and leasing property. Many believe that the tax system should not influence a tax-exempt entity's decision to purchase an asset (e.g., in the case of a State or local government through the proceeds of tax-exempt bonds) or lease the asset. In accordance with this view, prior tax legislation (generally the approach taken by Congress in 1984) attempted to minimize the potential distortion of depreciation on the decision by decelerating the depreciation deductions associated with property leased to tax-exempt entities. However, the effectiveness of this legislation has been questioned as new and innovative structures have been designed to minimize or circumvent such restrictions.

According to another view, tax subsidies should be made equally available to both taxable and tax-exempt entities. Under this view, it is inappropriate to prevent tax-exempt entities from receiving the benefits of tax incentives through leasing. For example, if Congress wants to subsidize certain types of investments, Congress should not care who is making the investment. Under this concept, there should be neutrality regardless of whether the investor is a tax-exempt entity or a taxable entity.

However, critics of this view cite at least two problems with this analysis. First, the notion that taxable and tax-exempt entities should be given equal incentives ultimately leads to the conclusion that these entities should be treated equally in all respects (i.e., tax-exempt status should be repealed). Second, providing tax-exempt entities with additional financial benefits through leasing could result in tax-exempt entities leasing, rather than owning, most or all of their buildings and equipment.

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[451] For example, in discussing the benefits of certain U.S./German leasing transactions a leasing industry trade publication stated "inaccurate reporting [by the German press] has created a wave of anti-leasing sentiment that is both unwarranted and the public purse equivalent of looking a gift horse in the mouth." It went on to state "part of the problem rests with the failure of the [leasing] industry to sell itself clearly and loudly. Lease product needs to be clearly marked -- a gift from the U.S." *See "The Lease Experience,"* Asset Finance International, May 2003.

Others argue that it is not necessary to have the leasing of property and the ownership of property treated alike for tax purposes because a "true lease" is different from outright ownership. However, if the leasing arrangement has factors that indicate it is economically equivalent to ownership by the lessee then the investments should be similarly taxed. Otherwise the tax system has influenced the investment decision between leasing property and owning property.

Privatization.–A fifth issue has been raised by some who contend that private parties can provide public services more economically than can governments. It is argued that leasing is a mechanism for promoting the "privatization" of public services and should be encouraged. The greater expertise of private providers, as well as their ability to bypass negotiations with public labor unions, Federal and State mandates, facility design or other criteria specified by public agencies, and delays in obtaining financing through public budgeting processes (e.g., debt ceilings and balanced budget requirements) are among the sources of the advantages cited for privatization. However, critics argue that the tax rules should not be used to supersede laws and procedures that the public itself, through its representatives in Congress and other governmental agencies, has imposed and can amend directly upon a full consideration and public debate of their merits. In addition, others highlight that many of the leasing transactions have not altered the party responsible for providing the services, or anything else, but, rather, have only altered who is considered the tax owner of the property. Critics also highlight that if there are economic advantages to privatizing certain governmental services, such advantages are separate, and occur apart from, any tax incentives.

Policy issues pertaining to leases with certain tax-exempt entities

As mentioned above, the relative importance of these policy issues varies according to whether the lessee is a Federal agency, a State or local governmental agency, a nonprofit organization, or a foreign government or person. The following discussion addresses the relative importance of these issues to each of these types of entities.

Federal government.–The main issues involved in leasing by Federal government agencies appear to be the distortion of the appropriations process, the inefficiency of tax-motivated leases, and the public's perception of the integrity of the Federal tax system. Leasing by a Federal agency distorts the appropriations process by shifting capital acquisition costs from the agency's budget to the U.S. Treasury in the form of reduced tax revenues. Thus, it reduces the control over spending normally exercised by the appropriations process by converting direct outlays, which require appropriations, into tax benefits, which do not. Leasing also shifts the disbursement of funds from the agency's procurement account to a possibly less scrutinized part of the agency's budget, such as an operations and maintenance account. When a Federal agency leases property, the cost of the property tends to be obscured in the agency's budget because the cost is reflected in the budget as ongoing rental payments rather than a more conspicuous authorization or annual outlay in the procurement section of the budget. In addition, leasing is inefficient and likely raises the total government cost of acquiring property. Finally, the sale of tax benefits by a Federal government agency may contribute to a public perception of inequity in the Federal income tax system.

State and local governments.–The main tax issues involved in State and local governmental leasing appear to be whether leasing is an appropriate mechanism to provide State and local government assistance and whether certain leasing transactions provide a double tax benefit to State and local governments.

Congress already provides targeted assistance to States through the appropriations process and also provides assistance through the tax system to State and local governments by means of the exclusion from Federal tax of interest paid on municipal bonds and the itemized deduction for certain State and local taxes. In addition, Congress has provided direct funding to States.[452] In these situations, Congress generally either directs the funds to specific activities (e.g., by direct appropriation) or limits the benefits by imposing rules that require the State and local governments to follow certain rules (e.g., tax-exempt bond limitations). In contrast, the benefits provided by leasing transactions are not subject to Congressional review or oversight.

Proponents of leasing claim that it is a mechanism to increase funding to maintain or provide public services that could not be offered because bond issues have been rejected or limits on indebtedness have been reached. However, critics argue that the federal tax Code ought not be used to supersede laws and procedures that the local residents have imposed and can amend directly upon a full consideration of their merits.

In some instances, State and local governments may be combining the benefits of leasing with Federal financial assistance by leasing assets that previously have been funded with tax-exempt obligations and grants by the Federal government. The proceeds of the sale may then be invested by the State or local government in investments, the interest on which is used to cover rental payments, meet other current operating expenses, and provide a sinking fund for repurchasing the property at the end of the lease term. Some have argued that this produces two financial benefits provided by the Federal government on the same asset, one enjoyed by the governmental entity (through the Federal financial assistance) and another enjoyed by the tax-exempt entity and the lessor (the tax benefits of depreciating the property).

Nonprofit organizations.–Leasing by nonprofit organizations generally raises similar tax policy issues as State and local governmental leasing. Congress currently provides other assistance to nonprofit organizations through the tax system (e.g., tax-exemption and deductibility of charitable contributions of property donated to such organizations).

Foreign governments and persons.–As is the case with any other lessee, a foreign person leasing property from a U.S. lessor may receive an indirect subsidy from the U.S. Treasury. If the foreign person is taxable by the United States on all the income generated by that property, the subsidy may be as justifiable as that provided to any other taxable user. However, if only a small portion of the income is taxable by the United States, or if the foreigner is not subject to U.S. tax because it is a foreign government or a foreign entity not doing business in the United States, then many of the same issues as those described above are raised. For example, information provided for leases that have been registered as tax shelters with the IRS highlights

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[452] *See e.g.,* Pub. L. 108-27, sec. 401, which provided $20 billion in direct funding to States to provide funding for essential government services, and for Medicaid.

that the vast majority of the value of qualified technological equipment is foreign use property that, absent the sale-leaseback transaction, would not be eligible for U.S. tax benefits. The types of assets that have been used in foreign qualified technological equipment leasing transactions include, among others, telecom equipment, baggage handling equipment, flight simulators, mail sorting equipment, automatic train control systems, air traffic control systems, electronic toll systems, automated food production lines, and automated fare collection systems.[453]

For U.S. produced goods, the subsidy for foreign investment might be justified as an export incentive. However, no similar justification exists where foreign produced goods are leased or where previously acquired goods (regardless of where produced) are sold and leased back. A related issue is the potential revenue cost if foreigners are able to take unrestricted advantage of U.S. tax subsidies by leasing property from U.S. lessors.

Specific policy issues with respect to the proposal

Inclusion of all service contracts in lease term.–The present-law depreciation rules applicable to tax-exempt use property subject to a lease were enacted to prevent tax-exempt entities from transferring to a taxable entity the tax benefits of accelerated depreciation on property used by the tax-exempt entity. These rules require that the leased property be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term. The policy requiring the recovery period be no less than 125 percent of the lease term was intended to ensure that the recovery period would more accurately reflect the economic life of the property.[454] To avoid the impact of these rules, a taxpayer leasing tax-exempt use property may seek to shorten the depreciable life of the asset by combining a shorter lease term with a subsequent service contract that would not be treated as part of the lease term.[455] Thus, the taxpayer is able to accelerate tax depreciation deductions and circumvent the tax policy rationale of the 125 percent rule. Including the service contract in the term of the lease for depreciation purposes will prevent this technique.

On the other hand, there are bona fide reasons for service contracts between taxable and tax-exempt entities. However, it is difficult to envision a non-tax business reason for a tax-exempt entity structuring a transaction that converts a 20, 30, or 40-year lease into a service

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[453] These transactions have included property from, among other countries, Australia, Austria, Canada, China, France, Germany, Netherlands, Portugal, Sweden, Switzerland, and the United Kingdom.

[454] In general, a taxpayer is not considered the owner of property if the lease extends beyond 80 percent of the useful life of the asset. Thus, property subject to a lease term that is for 80 percent of the property's useful life would be recovered over its economic life under this rule (80% x 125% = 1).

[455] Effectively, a service contract arrangement provides a relatively assured means of achieving a minimum investment expectation by the lessor without requiring such contract term to be included in the lease term. Removal of this feature would in some cases subject the lessor to additional economic risk unless the lease term is extended.

contract. Further, tax-exempt entities engaged in leasing transactions have indicated in internal correspondence that the service contracts are used to avoid Federal income tax issues, and that they never expect to ever take any other action than pay the buyout option and terminate the transaction, irrespective that such buyout is above projected fair market value.

Limitation on tax benefits from certain tax-exempt leases.–The proposal is intended to ensure that certain leasing transactions with tax-exempt entities not create a significant mismatch in the timing of income and deductions. The proposal generally is intended to be limited to leasing transactions in which the substance of the arrangement is the payment of a fee to the tax-exempt entity in exchange for the transfer of tax benefits to a taxable entity that can use such benefits. In these types of leasing arrangements, the arrangement is economically equivalent to ownership by the tax-exempt entity (lessee), and thus the investment should be taxed as such (i.e., the tax benefits of depreciation and other costs should be removed). In order to accomplish this result and deter such activity, the proposal adopts an approach that is similar to the rules addressing passive activity losses for individuals in that, like passive activity losses, recognition of net losses from the early years are deferred until corresponding net income (if any) is recognized by the taxpayer in later years (or upon termination of the leasing transaction). Advocates of the proposal argue that taxable U.S. corporations should not be permitted to take advantage of the special tax status of tax-exempt entities participating in a lease in order to generate U.S. tax benefits that can be used to shelter other unrelated income. Advocates of the proposal also argue that the mechanics of the passive activity loss rules provide an appropriate model for addressing the timing issues presented by certain leasing transactions with tax-exempt entities. Further, they argue that by incorporating exceptions for certain leases from the broad scope of this proposal it is appropriately targeted. Lastly, the proponents highlight that the leasing transactions are an inefficient mechanism for providing funds and do not afford Congress any oversight on the use of the subsidy provided.

Critics of the loss deferral proposal argue it is overly broad and could inappropriately affect leasing transactions with tax-exempt entities that are not primarily engaged in to shelter taxable income.[456] In addition, it can be argued that an alternative approach for addressing certain specific income and deduction mismatching problems could be achieved more effectively by modifying the class lives of property so that they more accurately reflect the economic useful life of such property, thus minimizing the ability to obtain significant tax benefits through mismatching of income and deductions.

Critics also may argue that, irrespective of arrangements (e.g., defeasance of lease obligations) that limit the risk of the parties involved, such arrangements are not legally binding and, similar to other non-binding business arrangements, should not impact the tax treatment of

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[456] On the other hand, some may argue that the proposal is not broad enough because it does not include lease transactions with U.S. corporations that have expiring net operating losses. In such situations, such corporations may be considered effectively tax-exempt to the same degree as State and local governments, nonprofit organizations, and foreign governments and persons. Thus, it could be argued that the proposal does not comprehensively preclude abusive lease transactions with tax-exempt entities because it does not apply to transactions with such corporations.

the transaction.[457] Critics may argue further that the abusive characteristics of the targeted leasing transactions are not merely a function of the presence of a tax-exempt accommodating party but, rather, are related to the absence of economic substance in the transaction and should be challenged on such basis. Lastly, critics may argue the transactions are no less efficient than other forms of Federal assistance.

Prior Action

Proposals to limit deductions associated with tax-exempt leasing and include all service contracts in the lease term were included in S. 1637, the "Jumpstart Our Business Strength (JOBS) Act," as passed by the Senate Committee on Finance on November 7, 2003. In addition, a proposal to limit deductions associated with tax-exempt leasing was included in the President's fiscal year 2000 budget proposal. A proposal to include all service contracts in the lease term was included in the President's fiscal year 2001 budget proposal.

[457] However, it should be noted, Treas. Reg. sec. 1.148-1(c)(2) states that if an issuer of tax-exempt bonds voluntarily sets up a sinking fund that it reasonably expects to use to pay debt service on the bonds, the amounts deposited in the sinking fund will be subject to the arbitrage rules.

H. Ensure Foreign Subsidiaries of U.S. Companies Cannot Inappropriately Avoid U.S. Tax on Foreign Earnings Invested in U.S. Property Through Use of the Exceptions for Bank Deposits

Present Law

In general, the subpart F rules[458] require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent such earnings are invested by the controlled foreign corporation in certain U.S. property.[459]

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.[460]

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer.[461]

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[458] Secs. 951-964.

[459] Sec. 951(a)(1)(B).

[460] Sec. 956(c)(1).

[461] Sec. 956(c)(2).

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*[462] ("*The Limited*") concluded that a U.S. subsidiary of a U.S. corporation was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. corporation could make deposits with the subsidiary under this exception (e.g., through the purchase of certificates of deposit), and avoid taxation of the deposits as an investment in U.S. property.

Description of Proposal

The proposal limits the bank deposit exception for foreign earnings invested in U.S. property as bank deposits to deposits with institutions regulated as banks.

Effective date.–This proposal is effective after the date of enactment.

Analysis

Policy issues

The result in *The Limited* is inconsistent with the policy underlying the bank deposit exception from the imposition of U.S. tax on repatriated foreign earnings. This exception is one of several exceptions that generally are designed to ensure that assets in the United States held by a controlled foreign corporation for business purposes are not characterized as a disguised repatriation. The result in *The Limited* inappropriately extends the exception for bank deposits to cases in which the deposits should be characterized as repatriations. Therefore, this exception should be clarified so that it applies only to deposits with financial institutions that actually are in the banking business.

Multiple options are available to clarify the bank deposit exception, with each option having certain advantages and disadvantages. One possible option would be to limit the present-law bank deposit exception to deposits made with unrelated persons carrying on the banking business. This approach would be similar to the present-law exception for investments in U.S. corporate stock and debt, which is limited to investments in stock and debt of unrelated issuers.[463] Unlike clarifying directly the term "carrying on the banking business", adding a related party prohibition to the existing exception would avoid reliance upon non-tax banking definitions and concepts which are subject to change and, in fact, have changed significantly in recent years. This approach would ensure that the bank deposit exception applies only to deposit recipients that are actively engaged in providing banking services to customers. On the other hand, a related party prohibition could affect U.S. banks with foreign operations that currently utilize the bank deposit exception, although this approach might be viewed alternatively in this regard as equalizing the treatment of such banks with other similarly situated taxpayers that have

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[462] 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

[463] *See* Sec. 956(c)(2)(F).

no banking business and, thus, cannot utilize the bank deposit exception to repatriate foreign earnings.

Another possible option would be to clarify the exception by reference to the status of the deposit recipient. The President's budget proposal reflects this approach by requiring that the deposit recipient be an institution regulated as a bank. Relying upon the regulatory definition of a "bank" to clarify the intended scope of the bank deposit exception generally would preclude the exception from applying to special purpose subsidiaries such as the one that was utilized successfully in *The Limited* case, while preserving the present-law application of the exception to U.S. banks with foreign operations. However, limiting the bank deposit exception to regulated banks would preclude the exception from applying to deposits with certain financial institutions that are not regulated as banks but nevertheless engage in providing active financial services to customers.

Another possible option would be to combine certain elements of the other options so that the bank deposit exception is limited to deposits with recipients that primarily earn banking or active financial services income from unrelated parties. Such an approach could curtail abuse of the bank deposit exception by taxpayers that are not viewed appropriately as financial institutions, while preserving the present-law application of the exception to U.S. banks and other financial institutions with foreign operations.

Complexity issues

The proposal can be expected to reduce the complexity of the tax law. By replacing the vague term "carrying on the banking business" with a more precise definition of the types of persons that may receive deposits under the exception, the proposal substantially eliminates the ambiguity that spawned the litigation resulting in *The Limited* decision.

Prior Action

H.R. 2896, American Jobs Creation Act of 2003, as favorably reported by the House Committee on Ways and Means on October 28, 2003, and S. 1637, Jumpstart our Business Strength (JOBS) Act, as favorably reported by the Senate Finance Committee on October 1, 2003, include a similar provision.

I. Modify Tax Rules for Individuals Who Give Up U.S. Citizenship or Green Card Status

Present Law

In general

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[464] with a principal purpose of avoiding U.S. taxes, the individuals is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax only on U.S.-source income[465] at the rates applicable to U.S. citizens for the 10-year period.

An individual who relinquishes citizenship or terminates residency is treated as having done so with a principal purpose of tax avoidance and is generally subject to the alternative tax regime if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[466] Certain categories of individuals (*e.g.*, dual residents) may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling

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[464] Under present law, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty).

[465] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

[466] The income tax liability and net worth thresholds under section 877(a)(2) for 2004 are $124,000 and $622,000, respectively. *See* Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

Estate tax rules with respect to expatriates

Special estate tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the test above). Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets.

Gift tax rules with respect to expatriates

Special gift tax rules apply to individual's who relinquish their citizenship or long-term residency within the 10 years prior to the date of death, unless he or she did not have a tax avoidance purpose (as determined under the rules above). The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination.

Information reporting

Under present law, U.S. citizens who relinquish citizenship and long-term residents who terminate residency generally are required to provide information about their assets held at the time of expatriation. However, this information is only required once.

Description of Proposal

The proposal replaces the present-law subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination with objective rules. Under the proposal, a former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $122,000 (adjusted for inflation after 2004) and his or her net worth does not exceed $2 million (adjusted for inflation after 2004); and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary may require. If a former citizen or long-term resident exceeds the monetary thresholds, that person also is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors.

Under the proposal, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

Except to the extent provided in regulations, individuals who would otherwise be subject to the alternative tax regime in a calendar year during the 10-year period following expatriation but who are physically present in the United States for more than 30 days in that calendar year generally are subject to U.S. tax on their worldwide income as though they were U.S. citizens or residents in that taxable year.

Certain gifts of stock of closely-held foreign corporations by a former citizens or former long-term resident are subject to U.S. gift tax. Annual reporting is required for individuals subject to the alternative tax regime, even if they have no U.S. tax liability that year.

Effective date.–The changes apply to individuals losing U.S. citizenship or long-term residency on or after date of first committee action.

Analysis

The proposal replaces the present-law subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination with objective rules. One of the difficulties in administering the present-law alternative tax regime is that the IRS is required to determine the subject intent of taxpayers who wish to relinquish citizenship or terminate residency if (1) taxpayers fall below the income tax liability or net worth thresholds or (2) the taxpayers exceed the thresholds but nevertheless are allowed to seek a ruling from the IRS to the effect that they did not have a principle purpose of tax avoidance. An objective rule may simplify the taxation of expatriates, but such a rule is more inflexible. However, because estate and gift taxes are often the principal motivating factors for persons who relinquish citizenship or terminate residency for tax-avoidance purposes, the higher net worth test may alleviate concerns about subjecting non-tax-motivated individuals to the regime. The $2 million net worth threshold is twice the unified credit exclusion amount for gift tax purposes, a level above which the transfer tax can be significant enough to be a motivating factor for relinquishing citizenship or terminating residency.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within exceptions for certain dual citizens and minors. Thus, objective exceptions for cases particularly likely to involve significant non-tax motivation replace the intent-based inquiry applicable to these cases under present law.

Under the proposal, tax-based rules are used to determine when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes. Under present law, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty). The proposal strengthens the present-law rules by denying the tax benefits of citizenship relinquishment or termination of long-term residency unless and until the IRS is provided the information necessary to enforce the alternative tax regime.

Individuals who are subject to the alternative tax regime in a calendar year during the 10-year period following expatriation but who are physically present in the United States for more than 30 days in that calendar year are subject to U.S. tax on their worldwide income as though

they were U.S. citizens or U.S. residents in that taxable year. Individuals who relinquish citizenship or terminate residency for tax purposes often do not want to fully sever their ties to the United States. Under present law, these individuals may continue to spend significant amounts of time - approximately four months every year - without being treated as a U.S. resident under the "substantial presence" test.[467] Consequently, the proposal acts as a deterrent to individuals who want to relinquish their citizenship or terminate their residency and maintain significant ties with the United States.

Under the present-law gift tax rules that apply to individuals who relinquish U.S. citizenship or terminate U.S. residency, an individual is subject to gift tax on gifts of stock of U.S. corporations made during the 10 years following citizenship relinquishment or residency termination. However, under present law, gifts of stock of foreign corporations that hold U.S.-situated assets are not subject to the gift tax as such transfers are under the estate tax in certain circumstances. Accordingly, the present-law rules incentivize former citizens and long-term residents who are subject to the alternative tax regime and who wish to gift U.S.-situated property to transfer such property to a foreign corporation[468] and then make a gift of stock of such corporation free of gift tax. Thus, the proposal rationalizes the gift and estate tax regimes.

Annual reporting is required for individuals subject to the alternative tax regime, even if they have no U.S. tax liability that year. Obtaining annual information on the income and assets of former citizens and long-term residents who are subject to the alternative tax permits the IRS to monitor more effectively both the income generated by the assets as well as any dispositions of assets that may be subject to the U.S. tax. Although additional reporting requirements may aid the IRS in enforcement of the alternative tax regime, the most significant practical obstacle to enforcement of the alternative tax regime remains - it applies to individuals who are not physically present in the United States.

With respect to the proposal as a whole, it should be noted that it does not eliminate all tax incentives for citizenship relinquishment and residency termination. Because the proposal is limited to U.S.-source income and U.S.-situated assets in the case of estate and gift tax, a tax incentive remains for taxpayers with foreign-situated assets to expatriate. Furthermore, the proposal is applicable during the 10-year period after citizenship relinquishment or residency termination, so taxpayers who are willing to wait for 10 years before disposing of their assets still have a tax incentive to expatriate.

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[467] The "substantial presence" test treats a noncitizen as a U.S. resident for U.S. Federal income tax purposes if he or she is present in the United States for a substantial period of time (i.e., 183 or more weighted days during a three-year period, weighted toward the current year). In general, an individual is considered to be a resident of the United States for estate and gift tax purposes if the individual is "domiciled" in the United States.

[468] Although such a transfer may be subject to section 367, the individual is still able to avoid a higher-rate transfer tax based on the total value of the property transferred at the cost of a lower-rate tax income tax on the appreciation in the property transferred.

Prior Action

This proposal is similar to recommendations contained in Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003. S. 1149, the "Energy Tax Incentives Act of 2003," and H.R. 2896, the "American Jobs Creation Act of 2003," also contained similar proposals. In contrast, the proposals in S. 1637, the "Jumpstart our Business Strength Act," and the Senate amendment to H.R. 2, the "Jobs and Growth Tax Relief Reconciliation Act of 2003," generally subject certain U.S. citizens who relinquish their U.S. citizenship and certain long-term residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination (the so called "mark-to-market" proposal).

J. Tax Shelter Exception to Confidentiality Privileges Relating to Taxpayer Communications

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to written communications regarding corporate tax shelters.

Description of Proposal

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, written communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner. The proposal also confirms that for purposes of the list maintenance requirements of section 6112, the identity of any person is not privileged.

Effective date.–The proposal generally is effective after the date of enactment.

Analysis

See the general discussion in section V.A. following the description of the proposals to combat tax avoidance transactions above.

Prior Action

The proposal was included in the President's Fiscal Year 2004 budget proposal. A number of legislative proposals have included the proposal.[469]

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[469] *See*, e.g., Joint Committee on Taxation, *Description of the "Highway Reauthorization and Excise Tax Simplification Act of 2004"* (JCX-5-04), January 29, 2004; House Ways and Means Committee Report of H.R. 2896, *American Jobs Creation Act of 2003*, (H. Rep. 108-393, November 21, 2003); Senate Finance Committee Report of S. 1637, *Jumpstart our Business Strength (JOBS) Act*, (S. Rep. 108-192, November 7, 2003).

K. Extend the Statute of Limitations for Reportable Transactions Where a Taxpayer Fails to Disclose on Return as Required

Present Law

In general, the Code requires that taxes be assessed within three years after the date a return is filed.[470] If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[471] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[472]

Description of Proposal

The proposal extends the statute of limitations with respect to a reportable transaction[473] if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a reportable transaction which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to any understatement of tax arising from the reportable transaction will not expire before the date which is one year after the earlier of (1) the date on which the taxpayer furnishes the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary.

Effective date.–The proposal is effective for taxable years with respect to which the period for assessing a deficiency has not expired on the date of enactment.

Analysis

See the general discussion in section V.A. above following the description of the proposals to combat tax avoidance transactions.

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[470] Sec. 6501(a). For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[471] Sec. 6501(e).

[472] Sec. 6501(c).

[473] The term "reportable transaction" has the same meaning as described in a previous proposal regarding the penalty for failure to disclose reportable transactions.

Prior Action

Several legislative proposals have included this proposal.[474]

[474] *See*, e.g., Joint Committee on Taxation, *Description of the "Highway Reauthorization and Excise Tax Simplification Act of 2004"* (JCX-5-04), January 29, 2004; House Ways and Means Committee Report of H.R. 2896, *American Jobs Creation Act of 2003*, (H. Rep. 108-393, November 21, 2003); Senate Finance Committee Report of S. 1637, *Jumpstart our Business Strength (JOBS) Act*, (S. Rep. 108-192, November 7, 2003).

L. Require Increased Reporting for Noncash Charitable Contributions

Present Law

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.[475] In the case of non-cash contributions, the amount of the deduction generally equals the fair market value of the contributed property on the date of the contribution.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000.

Taxpayers are required to obtain a qualified appraisal for donated property (other than money and publicly traded securities) with a value of more than $5,000.[476] Corporations (other than a closely-held corporation, a personal service corporation, or an S corporation) are not required to obtain a qualified appraisal. Taxpayers are not required to attach a qualified appraisal to the taxpayer's return, except in the case of contributed artwork valued at more than $20,000. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things, (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[477] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of

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[475] Charitable deductions are provided for income, estate, and gift tax purposes. Secs. 170, 2055, and 2522, respectively.

[476] P.L. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000). Under P.L. 98-369, a qualified appraisal means an appraisal prepared by a qualified appraiser that includes, among other things, (1) a description of the property appraised; (2) the fair market value of such property on the date of contribution and the specific basis for the valuation; (3) a statement that such appraisal was prepared for income tax purposes; (4) the qualifications of the qualified appraiser; (5) the signature and TIN of such appraiser; and (6) such additional information as the Secretary prescribes in such regulations.

[477] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

the qualified appraiser; and (e) the signature and TIN of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[478]

Description of Proposal

The proposal requires increased donor reporting for certain charitable contributions of property other than cash, inventory, or publicly traded securities. The proposal extends to C corporations the present law requirement, applicable to an individual, closely-held corporation, personal service corporation, partnership, or S corporation, that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds $5,000. The proposal also provides that if the amount of the contribution of property other than cash, inventory, or publicly traded securities exceeds $500,000, then the donor (whether an individual, a closely-held corporation, a personal services corporation, a partnership, an S corporation, or a C corporation) must attach either a copy of the qualified appraisal or an executive summary of the qualified appraisal to the donor's tax return. The executive summary must contain a description of the donated property, the methodology used by the appraiser, a description of the critical facts relied upon, and such additional information as the Secretary may require by form or regulation.

Under the proposal, the $5,000 and $500,000 amounts are indexed for inflation after December 2003.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003.

Analysis

The proposal addresses an anomaly of present law that excepts certain C corporations from the substantiation requirements applicable to other taxpayers that contribute property to charity. In addition, by requiring that additional information be disclosed for gifts in excess of $500,000, the proposal provides the IRS with more information about contributions, which could help prevent abusive valuations. The requirement that appraisers prepare an executive summary and state the appraisal methodology used could result in more informed appraisals in some cases.[479] Some might argue that if the central policy goal of the proposal is to prevent abuse in the valuation process, additional measures could be adopted -- for example, strengthening the substantial valuation misstatement penalty under section 6662, denying a deduction if all substantiation requirements are not met (e.g., filing Form 8283), and revisiting the standard of who is qualified to make appraisals under present law. The President's proposal also provides an exception from the qualified appraisal requirement for contributions of inventory property. Although some might argue that such an exception has merit because C corporations are in the best position to determine the value of their inventory, others argue that contributions of inventory are a potential area of abuse and that measures should be taken to ensure that appropriate values are being claimed for inventory contributions.

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[478] Treas. Reg. sec. 1.170A-13(c)(3).

[479] An alternative to providing an executive summary might be attaching a copy of the appraisal with the donor's return, as is required for artwork valued at more than $20,000.

Indexing for inflation the $5,000 and $500,000 amounts may be appropriate because such amounts arguably should automatically increase as inflation increases values of properties. Another approach would be to make periodic adjustments to the amounts should circumstances justify changes to the reporting thresholds.

Prior Action

No prior action.

M. Modify Certain Tax Rules for Qualified Tuition Programs

Present Law

Overview

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[480] A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program").[481] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program").[482] Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance.[483] Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.[484]

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner") whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions,

[480] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

[481] Sec. 529(b)(1)(A).

[482] Sec. 529(b)(1)(A).

[483] Sec. 529(e)(3)(A).

[484] Sec. 529(e)(3)(B).

recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.[485]

Under present law, section 529 does not establish eligibility requirements for designated beneficiaries. Accordingly, a beneficiary of any age may be named as a designated beneficiary. Special considerations generally apply to accounts that are funded by amounts subject to Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) laws.

Section 529 does not provide for any quantitative limits on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account, other than to require that the account provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.[486] Many qualified tuition programs impose limits on the maximum amount of contributions that may be made, or account balances that may accrue, for the benefit of a designated beneficiary.[487]

Under present law, contributions to a qualified tuition account must be made in cash.[488] A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to directly or indirectly direct the investment of any contributions (or earnings thereon),[489] and must provide separate accounting for each designated beneficiary.[490] A qualified

[485] Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.

[486] Sec. 529(b)(6).

[487] For example, a qualified tuition program might provide that contributions to all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit (e.g., $250,000), or that the maximum account balance for all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit. In the case of prepaid tuition contracts, the limit might be expressed in terms of a maximum number of semesters.

[488] Sec. 529(b)(2).

[489] Sec. 529(b)(4).

[490] Sec. 529(b)(3).

tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.[491]

Special rules apply to coordinate qualified tuition programs with other education benefits, including Coverdell education savings accounts, the HOPE credit, and the lifetime learning credit.[492]

Income tax treatment

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax, although it is subject to the tax on unrelated business income.[493] Contributions to a qualified tuition account (or with respect to a prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education expenses, no portion of the distribution is subject to income tax.[494] If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax,[495] and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).[496] A change in the designated beneficiary of an account or prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.[497]

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[491] Sec. 529(b)(5).

[492] Sec. 529(c)(3)(B)(v) and (vi).

[493] Sec. 529(a). An interest in a qualified tuition account is not treated as debt for purposes of the debt-financed property rules. Sec. 529(e)(4).

[494] Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

[495] Sec. 529(c)(3)(A) and (B)(ii).

[496] Sec. 529(c)(6).

[497] Sec. 529(c)(3)(C)(ii). For this purpose, "member of family" means, with respect to a designated beneficiary: (1) the spouse of such beneficiary; (2) an individual who bears a relationship to such beneficiary which is described in paragraphs (1) through (8) of section 152(a) (i.e., with respect to the beneficiary, a son, daughter, or a descendant of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law), or the spouse of any such individual; and (3) the first cousin of such beneficiary. Sec. 529(e)(2).

Gift and generation-skipping transfer (GST) tax treatment

A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary.[498] Such contributions qualify for the per-donee annual gift tax exclusion ($11,000 for 2004), and, to the extent of such exclusions, also are exempt from the generation-skipping transfer (GST) tax. A contributor may contribute up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.[499]

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax.[500] Those taxes may apply, however, to a change of designated beneficiary if the new designated beneficiary is in a generation below that of the old beneficiary.[501]

Estate tax treatment

Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual.[502] Amounts distributed on account of the death of the designated beneficiary, however, are includible in the designated beneficiary's gross estate.[503] If the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.[504]

Powers of appointment

Special income tax and transfer tax rules apply to instances where a person holds a power of appointment or certain other powers with respect to property. In general, a power of appointment includes all powers which are in substance and effect powers of appointment

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[498] Sec. 529(c)(2)(A).

[499] Sec. 529(c)(2)(B).

[500] Sec. 529(c)(5)(A).

[501] Sec. 529(c)(5)(B). A technical correction has been introduced that also would impose gift tax and GST tax on a change in the designated beneficiary if the new beneficiary is not a member of the family of the old beneficiary.

[502] Sec. 529(c)(4)(A).

[503] Sec. 529(c)(4)(B).

[504] Sec. 529(c)(4)(C).

regardless of the nomenclature used in creating the power and regardless of local property law connotations, and may include, for example, the power to consume or appropriate the property, or to affect the beneficial enjoyment of principal or income through a power to revoke, alter or amend the terms of the instrument.[505] The nature of the power held by a person affects whether the holder of the power is taxed on the income on the property, and whether the property subject to the power is treated as includible within the estate of the holder of the power or subject to gift tax.[506]

Description of Proposal

Overview

The proposal modifies certain income tax, gift tax, generation-skipping transfer tax, and estate tax rules with respect to changes in designated beneficiaries of qualified tuition accounts. The proposal also modifies the requirements of a qualified tuition program by imposing new eligibility rules for designated beneficiaries, and requiring that a savings account or prepaid tuition contract established under a qualified tuition program be a custodial arrangement maintained for the benefit of a designated beneficiary. The proposal modifies the present law provisions regarding the imposition of the 10-percent additional tax, and imposes new excise taxes on amounts that are used other than for qualified higher education expenses.

New eligibility requirements for designated beneficiaries

The proposal imposes new eligibility requirements for designated beneficiaries of qualified tuition accounts. Only an individual under age 35 is permitted to be the designated beneficiary of a qualified tuition account. When a designated beneficiary reaches age 35, a new eligible designated beneficiary must be appointed, or the account or prepaid benefit is treated as distributed to the designated beneficiary, thereby triggering potential income taxes, and either the 10-percent additional tax or an excise tax relating to the failure to use the distributed amounts for qualified higher education expenses. Failure to satisfy the under age 35 rule at the time the account is established results in the account failing to constitute a qualified tuition account.[507]

Changes in designated beneficiaries

The proposal modifies present law by providing that a change in the designated beneficiary of a qualified tuition account does not cause the imposition of gift tax or GST tax, regardless of whether the new designated beneficiary is in a generation below that of the former designated beneficiary. The proposal also provides that gift tax and GST tax would not be imposed even if the new designated beneficiary is not a member of the family of the old

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[505] Sec. 20.2041-1(b)(1). *See also* secs. 674, 2041, and 2514.

[506] Powers of appointment are often classified as “general powers of appointment” or as “limited” or “special” powers of appointment.

[507] In such cases, the otherwise generally applicable income tax and transfer tax rules, rather than section 529, would apply to the account or contract.

beneficiary. The proposal modifies the income tax treatment of a change in a designated beneficiary to provide that a change of designated beneficiary to a new eligible designated beneficiary who is not a member of the family of the old beneficiary is not treated as a distribution for income tax purposes.[508]

The proposal provides that upon the death of a designated beneficiary, the account is treated as distributed to the estate of the designated beneficiary, thereby triggering potential income tax, additional tax or excise tax, and estate tax consequences, unless a new eligible designated beneficiary is named in a timely manner.

Custodial arrangement for benefit of a designated beneficiary

The proposal requires that a qualified tuition account be a custodial arrangement maintained for the benefit of a designated beneficiary. Under the proposal, no person other than the designated beneficiary may possess a beneficial interest in the account.

Under the proposal, there is a single individual (the custodian) that the administrator may look to for account decisions and reporting. The custodian is the only person who may change the designated beneficiary, make investment decisions, direct that a distribution be made (for qualified higher education expenses or otherwise), or terminate the account or contract. The custodian may not change the designated beneficiary to the custodian, the custodian's spouse, or to an employee or creditor of the custodian. Distributions may be made only to the person who is the designated beneficiary at the time of the distribution, except that a custodian may receive a distribution in the limited case where the designated beneficiary dies or becomes incapacitated and the designated beneficiary has no spouse, siblings, or descendants.

Imposition of excise tax on nonqualifying distributions

The proposal retains the present-law income tax treatment of distributions from a qualified tuition account that are used for qualified higher education expenses. Such distributions are not subject to income tax, regardless of the distributee's identity. The proposal modifies present law with respect to distributions that are used other than for qualified higher education expenses. Distributions used for purposes other than qualified higher education expenses are subject to income tax on the earnings portion of the distribution. Further, the income portion of the first $50,000 in cumulative nonqualified distributions to a designated beneficiary is subject to a 10-percent additional tax (unless the distribution is made on account of death or disability of the beneficiary or receipt of a scholarship by the beneficiary). Nonqualified distributions in excess of $50,000 but less than or equal to $150,000 (computed on a cumulative basis for each designated beneficiary, including for this purpose the entire amount of the distribution, not just earnings) are subject to a new excise tax imposed at the rate of 35 percent. Nonqualified distributions in excess of $150,000 (computed on a cumulative basis for each designated beneficiary, including for this purpose the entire amount of the distribution, not just

[508] This change is proposed in order to be consistent with the objective of imposing no taxes on a change of designated beneficiary so long as the new beneficiary is an eligible designated beneficiary and the funds are not used for nonqualified purposes.

earnings) are subject to an excise tax imposed at the rate of 50 percent. The excise tax is required to be withheld by the program administrator.

Changes in trust contribution rules

The proposal modifies the rules applicable to trusts making contributions to qualified tuition accounts, to clarify the tax treatment with respect to such arrangements. The proposal contemplates that a trust could establish a qualified tuition savings account or a prepaid tuition contract in limited circumstances, provided that the trust is the only person authorized to make contributions to the account. This assumes that, because of the trustee's fiduciary obligations, the trustee would also serve as custodian. Special rules would be required to address the tax treatment of contributions made by the trust to the account or contract, and the recovery of contributions and earnings by the trust from the account or contract.

Changes in reporting requirements

The proposal provides that reporting requirements applicable to qualified tuition accounts would be modified. For example, new reporting requirements would be established to facilitate the administration of excise tax withholding by administrators. Such requirements might include certifications provided by designated beneficiaries to administrators of qualified tuition programs, so that administrators may withhold appropriate amounts of excise taxes with respect to distributions used other than for qualified higher education expenses.

Grant of regulatory authority to Treasury

The proposal grants the Secretary of the Treasury broad regulatory authority to ensure that qualified tuition accounts are used in a manner consistent with Congressional intent.

Effective dates

The proposal generally is effective for qualified tuition accounts (including savings accounts and prepaid tuition contracts) established after the date of enactment of the proposal, including prepaid tuition contracts if additional prepaid tuition benefits are purchased on or after the date of enactment of the proposal. The proposal does not apply to prepaid tuition contracts that are fully funded as of the date of enactment, or to prepaid tuition contracts for which additional contributions are required to be made under the terms of the program if such contribution amounts relate to prepaid tuition benefits purchased before the date of enactment. The proposal does not apply to qualified tuition savings accounts that are in existence on the date of enactment unless an election is made to be covered by the new rules. No additional contributions to savings accounts in existence on the date of enactment of the proposal would be permitted without such election.[509]

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[509] In cases where an existing account or contract is subject to the new rules, the entire account or contract is subject to the new rules, not just that portion of the account or contract that relates to contributions made, or prepaid benefits acquired, after the date of enactment.

The modified reporting requirements apply after the date of enactment of the proposal to all qualified tuition accounts (including savings accounts and prepaid tuition contracts).

Analysis

Overview

The President's budget proposal addresses certain transfer tax anomalies with regard to changes in designated beneficiaries by providing that a change of beneficiary to an eligible beneficiary will not constitute a transfer for gift or generation-skipping transfer tax purposes, or a distribution for income tax purposes. In addition, by requiring that no person other than a designated beneficiary possess any beneficial interest in a qualified tuition account, the proposal attempts to more closely align the gift tax treatment of contributions to qualified tuition accounts (i.e., a completed gift of a present interest to the designated beneficiary) with the treatment of contributions under generally applicable transfer tax principles. The proposal addresses potential abuses of qualified tuition accounts by establishing eligibility rules for designated beneficiaries, and imposing an excise tax on distributions that are not used for qualified higher education expenses.

Section 529 transfer tax treatment and generally applicable transfer tax provisions

Overview

Certain aspects of present-law section 529 depart from otherwise generally applicable transfer tax principles. For example, present law treats a contribution to a qualified tuition account as a completed gift of a present interest to the designated beneficiary,[510] even though in most instances, the designated beneficiary possesses no rights to control the qualified tuition account or withdraw funds, and such control (including the right to change beneficiaries or to withdraw funds, including for the benefit of someone other than the designated beneficiary) is vested in the account owner. Absent section 529, such contributions generally would not be treated as completed gifts to the designated beneficiary under otherwise applicable transfer tax principles.[511] Further, present section 529 does not address the transfer tax consequences of a change of account owners of a qualified tuition account.[512]

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[510] Sec. 529(c)(2).

[511] Under otherwise applicable transfer tax principles, the designated beneficiary's lack of control over the qualified tuition account generally would be regarded as a future interest, and any completed gift of a present interest would be regarded as having been made from the contributor to the account owner (rather than to the designated beneficiary). In cases where the contributor and the account owner are the same person, no gift would take place under generally applicable transfer tax principles.

[512] A change of account owner might be regarded as a completed gift of a present interest from the old account owner to the new account owner, or as having no tax consequences because a completed gift had been made to the designated beneficiary. The President's budget proposal addresses the present uncertainty in the law, but not by addressing changes in account owners.

Treatment of changes of designated beneficiaries

Under present-law section 529, a change of designated beneficiary to a beneficiary who is in a generation lower than the former beneficiary constitutes a taxable gift, even though the new designated beneficiary would, under otherwise applicable transfer tax principles, be regarded as not receiving a completed gift. Further, present-law section 529 does not identify which party is responsible for payment of the transfer tax when it is imposed in such instances. Also, under present-law section 529, there is no express requirement that the multiple annual present interest exclusion is available only if there is a present intent to allow the designated beneficiary to receive the benefits of the qualified tuition program.

Present law also has different change-of-beneficiary rules for income tax and transfer tax purposes. A change of beneficiary to a person who is not a member of the same family as the old beneficiary is treated as a distribution for income tax purposes, regardless of whether the new beneficiary is in a lower generation than the former beneficiary. Under present law, a change of beneficiary to a person who is in a lower generation than the former beneficiary is treated as a transfer for transfer tax purposes, regardless of whether the new beneficiary is of the same family as the former beneficiary.

The proposal eliminates these disparities and provides that a change of beneficiary will not be treated as a distribution or transfer, respectively, for income tax or transfer tax purposes, provided that the new beneficiary has not reached age 35, regardless of the respective generations of the beneficiaries or whether they are members of the same family.

Because the proposal expands the class of permissible successor designated beneficiaries without the imposition of any income or transfer taxes, individuals interested in establishing a qualified tuition account as a means to fund qualified higher education expenses for their children, relatives, or others, might view these changes as being a liberalization and simplification of existing law.

Custodial arrangement requirement

A significant aspect of the proposal is the change that requires that qualified tuition savings accounts and prepaid tuition contracts established under qualified tuition programs constitute custodial arrangements maintained for the benefit of designated beneficiaries. This aspect of the proposal is a significant change from the terms and conditions of many existing qualified tuition programs, which generally permit account owners to have the flexibility to terminate the accounts or otherwise withdraw funds for any purpose, subject only to the tax penalties associated with using the funds other than for qualified higher education expenses. Individuals interested in establishing qualified tuition accounts as a means to fund higher education expenses for their children, relatives, or others, may view these changes as being overly restrictive, and might choose instead to use alternative means to fund for higher education expenses.

Rather, the proposal treats the account owner as a custodian for the benefit of a designated beneficiary, and a mere change in custodian would have no tax consequences under the proposal.

Also, the nature of the proposed custodial arrangement does not fully align the proposed transfer tax treatment of section 529 plans with otherwise applicable transfer tax principles. Although the proposal curtails the custodian's rights to account assets generally to provide that the assets must be used for the benefit of a designated beneficiary, the designated beneficiary does not become the owner of the account's assets under generally applicable transfer tax principles. Under the proposal, the designated beneficiary does not have the right to withdraw funds for education purposes or for other uses, terminate the account, make investment decisions, or change beneficiaries. Absent such or similar rights, the designated beneficiary would not be viewed as receiving a completed gift of a present interest under generally applicable transfer tax principles. Rather, the custodian's rights to make investment decisions, terminate the account, direct that distributions be made for education or otherwise, and change beneficiaries, might resemble the bundle of rights that a person holding a special power of appointment over the account's assets might possess, or arguably as treating the custodian as the owner of the account's assets for transfer tax purposes.[513] Perhaps the most important right that the custodian possesses under the proposal, for transfer tax purposes, is that of changing the designated beneficiary to any person who is under age 35 (except for prohibitions against naming the custodian and certain persons with specified relationships to the custodian as a designated beneficiary). As long as the custodian may change the designated beneficiary, there is no assurance that the account benefits will be used for the benefit of a specific designated beneficiary.[514] On the other hand, the proposal eliminates one of the most significant incongruities in present-law section 529 that treats the designated beneficiary as the donee even though the arrangement generally allows the account owner to withdraw the funds at any time and for any purpose.

It is unclear how the proposal would apply to accounts established pursuant to the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA). Further, it is unclear how the proposed custodian rules would be interpreted for purposes of (or whether such rules would be consistent with) various state laws, including, for example, laws regarding fiduciary duties or accounting for assets subject to custodial arrangements established under such laws.

The proposal generally does not impose the new custodial requirements on existing qualified tuition accounts, unless an existing savings account elects to be covered by the new rules, or additional prepaid benefits are purchased with respect to existing accounts.

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[513] Under the proposal, however, the custodian generally is prohibited from using the account's assets for the benefit of the custodian.

[514] The proposal takes steps to increase the likelihood that the funds will be used for the benefit of a designated beneficiary, but by permitting designated beneficiary changes to virtually any person under age 35, does not ensure that any specific beneficiary will be the beneficiary of the account's assets.

Potential abuses addressed by the proposal

Establishing eligibility requirements for designated beneficiaries

The proposal attempts to address potential abuses of qualified tuition accounts that might result from taxpayers establishing multiple accounts for multiple beneficiaries, and taking advantage of the section 529 income tax and transfer tax rules without ever using the money for qualified higher education expenses. The proposal establishes the under age 35 requirement for designated beneficiaries to promote the use of the funds for education purposes while the beneficiary is relatively young. Some might view this age as too young, given the changing economy and the need for many workers older than age 35 to obtain education to "retool" for changing circumstances. Age 35 is more generous than Coverdell limits (age 30), however, but not so generous as to encourage the use of these accounts for retirement savings. Also, the proposal permits taxpayers to redesignate new beneficiaries, without income tax or transfer tax consequences, so long as the new beneficiary is under age 35. This could result in a qualified tuition account being established and maintained for many generations without income tax or transfer tax liability being imposed, because the funds have not been distributed and used for purposes other than to pay qualified higher education expenses. Accordingly, some might argue that the under age 35 rule is too liberal, and that a maximum duration (for example, 50 years) should be established, at which time the account must be used for education expenses or distributed to the then-designated beneficiary, with the imposition of all appropriate income tax and transfer tax at that time.

Excise tax on amounts used other than for qualified higher education expenses

The proposal attempts to discourage substantial multi-generational accumulations of qualified tuition account assets by imposing new excise taxes on distributions that are ultimately used other than for qualified higher education expenses. The proposed excise tax is imposed only if an actual or deemed distribution (for example, upon the failure to appoint a new eligible designated beneficiary upon the former beneficiary's death or attaining age 35) occurs and the distributed amounts are not used for qualified higher education expenses. In such cases, excise taxes on the entire amount of a distribution that exceeds certain cumulative thresholds, including on both the principal and earnings components, would be imposed. Such excise taxes are intended to serve as deterrents to using the funds other than for qualified higher education expenses. However, the excise taxes are not imposed unless an actual or deemed distribution occurs, and thus would not be imposed so long as the funds are maintained in a qualified tuition account that continues to be held for the benefit of an eligible designated beneficiary. The proposal does not impose a specific deadline by which time the funds must be used for education expenses or become subject to income, excise, and transfer taxes.

Some may argue that this proposal does not go far enough to deter (or in fact may create an opportunity to achieve) substantial multi-generational accumulations of qualified tuition account assets, and that a better approach would be to impose caps on the amounts that can be contributed to such accounts, or on the length of time that such assets can be held. Enforcing such caps, however, would impose significant administrative burdens on administrators, taxpayers, and the IRS. Others may argue that the present-law requirement that the account or contract provide adequate safeguards to prevent contributions on behalf of a designated

beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary, combined with the maximum contribution or account balance limits established by many of the various qualified tuition programs, adequately address any concerns that such accounts might be used to improperly accumulate assets for purposes other than providing for qualified higher education expenses of the designated beneficiary. Others may counter that program-imposed limits oftentimes are applied on a per-State basis, and further, that the ability of an individual to establish accounts for an unlimited number of designated beneficiaries means there are no effective limits under present law.

Prior Action

No prior action.

VI. TAX ADMINISTRATION PROVISIONS AND UNEMPLOYMENT INSURANCE

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 removes the following from the list of violations requiring termination: (1) the late filing of refund returns; and (2) employee versus employee acts. The proposal also adds unauthorized inspection of returns and return information to the list of violations. Additionally, the proposal requires 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 retains 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 is effective on the date of enactment.

Analysis

Policy issues

Late filing of refund returns

The proposal has 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.[515] Proponents of the proposal relating to late filings may 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 may 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 may point out that Congress believed it appropriate to include such allegations in the statutory list of grounds for IRS employee termination. They may 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 increasing the inappropriate use of allegations of inappropriate behavior against other employees for purposes of intimidation, harassment, or retribution).

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

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

returns and return information illegal, with violations punishable by fine, imprisonment, and 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 may 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 may 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 can 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 can be done by disclosing sensitive tax information to a third party than by looking at a return out of curiosity. Thus, the proposal can 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 discipline 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

An identical proposal was included in the President's fiscal year 2003 and 2004 budget proposals.[516] An identical proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. A substantially similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004.

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[517] to

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[516] The original provisions were enacted in the IRS Restructuring and Reform Act of 1998.

[517] 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.

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)).

Description of Proposal

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

The proposal also modifies 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 applies are: (1) requests for a collection due process hearing; (2) installment agreements; and (3) offers-in-compromise. First, the proposal permits the IRS to dismiss such requests. Second, the proposal permits 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 permits the IRS to maintain records of frivolous submissions by taxpayers.[518] The proposal also requires that this designation be removed after a reasonable period of time if the taxpayer makes no further frivolous submissions to the IRS.

The proposal requires 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 is effective for submissions made on or after the date of enactment.

Analysis

In general

Genuinely frivolous returns and submissions are those that 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 do not raise these frivolous arguments.

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 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

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[518] 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)).

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.

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

A substantially similar proposal was included in the President's fiscal year 2003 budget proposal.[519] An identical proposal was included in the President's fiscal year 2004 budget proposal. A substantially similar proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. A substantially similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004.

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.[520]

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

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[519] The fiscal year 2003 budget proposal also applied to taxpayer assistance orders.

[520] Sec. 6331(k).

Effective date.–The proposal is effective for installment agreements entered into on or after the date of enactment.

Analysis

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 some details have not been specified. For example, the proposal 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 immediate payment of the balance). Such a requirement could increase the total amount collected under the proposal. Also, if the unpaid balance remaining at the conclusion of the partial payment installment agreement 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[521] 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.[522] 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

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

[522] Sec. 7122.

installment agreement to achieve the same effect: a reduction in the total amount of tax they will have to pay.

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.[523] 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 but 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

An identical proposal was included in the President's fiscal year 2003 and 2004 budget proposals. A substantially similar proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. A substantially similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004.

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.

[523] Sec. 6159(c).

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails 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.[524]

Description of Proposal

The proposal grants the IRS authority to terminate an installment agreement when a taxpayer fails to timely make a required Federal tax deposit[525] 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 is effective for failures occurring on or after the date of enactment.

Analysis

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 reinstating 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

[524] Sec. 6159(b).

[525] 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).

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.

The proposal is 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

An identical proposal was included in the President's fiscal year 2003 and 2004 budget proposals. An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004.

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[526] and is a court of limited jurisdiction.[527]

Description of Proposal

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

Effective date.–The proposal applies to IRS Office of Appeals determinations made after the date of enactment.

Analysis

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

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[526] Sec. 7441.

[527] Sec. 7442.

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.

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.[528]

Some believe that present law "entitles a taxpayer patently seeking delay to achieve his goal by refiling in the District Court."[529] The proposal would provide simplification benefits by eliminating this opportunity for delay.

Prior Action

A substantially similar proposal was included in the President's fiscal year 2003 and 2004 budget proposals.[530] An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004. 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.[531]

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).

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[528] 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.

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

[530] There was a slight difference in the effective dates of those proposals.

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

Description of Proposal

The proposal repeals 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. The Secretary must establish standards for determining when a written opinion is required with respect to a compromise.

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

Analysis

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 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.[532]

Prior Action

An identical proposal was included in the President's fiscal year 2003 and 2004 budget proposals. An identical proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004. The $50,000 threshold was raised from $500 in 1996.[533]

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

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

B. Initiate IRS Cost Saving Measures

1. Allow the Financial Management Service to retain transaction fees from levied amounts

Present Law

To facilitate the collection of tax, the IRS can generally levy upon all property and rights to property of a taxpayer (sec. 6331). With respect to specified types of recurring payments, the IRS may impose a continuous levy of up to 15 percent of each payment, which generally continues in effect until the liability is paid (sec. 6331(h)). Continuous levies imposed by the IRS on specified Federal payments are administered by the Financial Management Service (FMS) of the Department of the Treasury. FMS is generally responsible for making most non-defense related Federal payments. FMS is required to charge the IRS for the costs of developing and operating this continuous levy program. The IRS pays these FMS charges out of its appropriations.

Description of Proposal

The proposal allows FMS to retain a portion of the levied funds as payment of these FMS fees. The amount credited to the taxpayer's account would not, however, be reduced by this fee.

Effective date.–The provision is effective on the date of enactment.

Analysis

Proponents believe that altering the bookkeeping structure of these costs will provide for cost savings to the government.

Prior Action

An identical proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003. An identical proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004.

2. 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 extends 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 is not changed.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2003; these returns will be filed in 2005.

Analysis

In general, the goal of the proposal is to 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 but file a paper return (and that doing so is less of a burden on them) by encouraging those individuals to file their returns electronically. The proposal could, in addition, encourage return preparers to file electronically, in that it will give the preparers additional time to prepare the returns.

Taxpayers must both file and pay electronically in order to receive the benefit of the proposed extension of time. There are currently two electronic mechanisms[534] for paying the balance due[535] with the return: (1) credit card; or (2) electronic funds withdrawal.[536] Credit card providers charge a convenience fee[537] in addition to the amount of tax due, which may deter some individuals from paying the balance due electronically.

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[534] 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.

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

[536] This permits the IRS to withdraw the amount owed from the taxpayer's bank account electronically (*see* E-Payment Options for 2003, FS-2003-7, January 2003); it is not offered as an option when a paper return is filed.

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

Another factor that may deter significant numbers of individuals from availing themselves of the extended Federal due date is whether States and local governments that impose income taxes provide parallel extensions of time to file. If they do not, and if the State or local income tax requires completion of the Federal return first (which many but not all do), taxpayers in those jurisdictions may not be able to avail themselves of the extended due date for Federal returns.

Although the proposal may in many instances reduce administrative burdens, having two different Federal 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 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 tax filing season, many (but not all) tax forms are eligible for electronic filing.[538] 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. Similar situations could arise if there are break downs in the transmission process.

Prior Action

A similar proposal was included in the President's fiscal year 2003 budget proposal. An identical proposal was included in the President's fiscal year 2004 budget proposal. A similar proposal was contained in the "Taxpayer Protection and IRS Accountability Act of 2003," as passed by the House of Representatives on June 19, 2003.

[538] *See* IRS Publication 1345A, Filing Season Supplement for Authorized IRS E-File Providers, pp. 22-3 (December 19, 2003).

C. Repeal of Section 132 of the Revenue Act of 1978

Present Law

General tax treatment of nonqualified deferred compensation

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[539] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income in situations where nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451. Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it can be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

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[539] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[540] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

Rulings on nonqualified deferred compensation

In the 1960's and early 1970's, various IRS revenue rulings considered the tax treatment of nonqualified deferred compensation arrangements.[541] Under these rulings, a mere promise to pay, not represented by notes or secured in any way, was not regarded as the receipt of income for tax purposes. However, if an amount was contributed to an escrow account or trust on the individual's behalf, to be paid to the individual in future years with interest, the amount was held to be includible in income under the economic benefit doctrine. Deferred amounts were not currently includible in income in situations in which nonqualified deferred compensation was payable from general corporate funds that were subject to the claims of general creditors and the plan was not funded by a trust, or any other form of asset segregation to which individuals had any prior or privileged claim.[542] Similarly, current income inclusion did not result when the employer purchased an annuity contract to provide a source of funds for its deferred compensation liability if the employer was the applicant, owner and beneficiary of the annuity contract, and the annuity contract was subject to the general creditors of the employer.[543] In these situations, deferred compensation amounts were held to be includible in income when actually received or otherwise made available.

Proposed Treasury regulation 1.61-16, published in the Federal Register for February 3, 1978, provided that if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year.[544]

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[540] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

[541] The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60-31, 1960-1 C.B. 174.

[542] Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 69-49, 1969-1 C.B. 138.

[543] Rev. Rul. 72-25, 1972-1 C.B. 127. *See also*, Rev. Rul. 68-99, 1968-1 C.B. 193, in which the employer's purchase of an insurance contract on the life of the employee did not result in an economic benefit to the employee if all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable only to the employer.

[544] Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978[545] was enacted in response to proposed Treasury regulation 1.61-16. Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.[546]

Description of Proposal

The Administration's proposal repeals section 132 of the Revenue Act of 1978 and amends the Code to authorize the Secretary to issue rules to address inappropriate nonqualified deferred compensation arrangements. Under the proposal, examples of inappropriate nonqualified deferred compensation arrangements include arrangements under which the availability of deferred payments is not actually subject to a substantial limitation, arrangements under which assets are, in effect, placed beyond the reach of the employer's general creditors, and arrangements under which the individual otherwise attempts to defer tax on amounts with respect to which economic value is realized.

Under the proposal, it is expected that new guidance would address when an individual's access to compensation is considered subject to a substantial limitation, the extent to which company assets can be designated as available to meet deferred compensation obligations, and when an arrangement is treated as funded. The new guidance would not include finalization of Proposed Treasury Regulation section 1.61-16.

Effective date.–The proposal is effective on the date of enactment.

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[545] Pub. L. No. 95-600.

[546] The legislative history to the provision states that the Congress believed that the doctrine of constructive receipt should not be applied to employees of taxable employers as it would have been under the proposed regulation. The Congress also believed that the uncertainty surrounding the status of deferred compensation plans of taxable organizations under the proposed regulation was not desired and should not be permitted to continue.

Analysis

In general

Nonqualified deferred compensation is a common form of executive compensation. A variety of tax principles and Code provisions are used in determining the appropriate tax treatment for nonqualified deferred compensation. There are no clear rules governing many aspects of deferred compensation arrangements. As a result, arrangements have developed based on varying interpretations of authority that may not be strictly applicable to the situation in question. The restriction imposed by section 132 of the Revenue Act of 1978 has prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law.

The Joint Committee staff has recommended the repeal of section 132 of the Revenue Act of 1978.[547] Repealing section 132 would allow Treasury to provide more guidance to taxpayers and may also help to stem inappropriate practices. Especially given the lack of statutory rules regarding specific arrangements, the lack of administrative guidance in this area allows taxpayers latitude to create and promote arrangements which push the limit of what is allowed under the law. Because of the lack of rules and guidance in this area, the current state of practice has, to a great extent, evolved from variations of private letter rulings issued by the IRS to various taxpayers. Taxpayers continue to create new variations of arrangements that, in their basic form, are generally perceived as allowed by the IRS. Guidance issued by the Secretary should address current inappropriate practices, such as accelerated distributions and certain suspect techniques used to prevent an arrangement from being considered funded, but should also be sufficiently broad so that new inappropriate arrangements cannot be developed.

The effectiveness of the proposal will depend on the specifics of any guidance issued. Additionally, in interpreting present law, guidance issued by the Secretary may not be able to address all practices that are generally viewed as inappropriate. Additional statutory changes may also be necessary.

Complexity issues

The proposal has elements that may both increase and decrease complexity depending on the specific guidance issued by the Secretary. Clearer rules in the deferred compensation area would add simplification. Whether any particular rules are complex will depend on the specific rules. While the existence of clear rules in the deferred compensation area would add simplification, because a variety of tax principles and Code provisions are used in determining the appropriate tax treatment for nonqualified deferred compensation, additional complexity could result if new guidance is unclear. Any complexity associated with deferred compensation rules is elective, as the decision to defer compensation is voluntary.

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[547] *See* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

Prior Action

An identical proposal was included in the President's fiscal year 2004 budget proposal.

D. Permit Private Sector Debt Collection Companies to Collect Tax Debts

Present Law

In fiscal years 1996 and 1997, the Congress earmarked $13 million for IRS to test the use of private debt collection companies. There were several constraints on this pilot project. First, because both IRS and OMB considered the collection of taxes to be an inherently governmental function, only government employees were permitted to collect the taxes. The private debt collection companies were utilized to assist the IRS in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed at that point to make a payment, the taxpayer was transferred from the private debt collection company to the IRS. Second, the private debt collection companies were paid a flat fee for services rendered; the amount that was ultimately collected by the IRS was not taken into account in the payment mechanism.

The pilot program was discontinued because of disappointing results. GAO reported[548] that IRS collected $3.1 million attributable to the private debt collection company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million to the IRS because collection personnel were diverted from their usual collection responsibilities to work on the pilot.

The IRS has issued an extensive Request for Information concerning its possible use of private debt collection companies.[549]

In general, Federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States.[550] That provision does not apply to the collection of debts under the Internal Revenue Code.[551] It is unclear whether additional statutory authority is necessary to authorize the IRS to utilize private debt collection companies.

Description of Proposal

The proposal permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities and to arrange payment of those taxes by the taxpayers. Several steps are involved. First, the private debt collection company contacts the taxpayer by letter.[552] If the taxpayer's last known address is incorrect, the private debt collection

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[548] GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

[549] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. The basic request for information is 104 pages, and there are 16 additional attachments.

[550] 31 U.S.C. 3718.

[551] 31 U.S.C. 3718(f).

[552] Several portions of the proposal require that the IRS disclose confidential taxpayer information to the private debt collection company. Section 6103(n) permits disclosure for "the

company searches for the correct address. The private debt collection company is not permitted to contact either individuals or employers to locate a taxpayer. Second, the private debt collection company telephones the taxpayer to request full payment.[553] If the taxpayer cannot pay in full immediately, the private debt collection company offers the taxpayer an installment agreement providing for full payment of the taxes over three years.[554] If the taxpayer is unable to pay the outstanding tax liability in full over a three-year period, the private debt collection company obtains financial information from the taxpayer and will provide this information to the IRS for further processing and action by the IRS.

The proposal specifies several procedural conditions under which the proposal would operate. First, provisions of the Fair Debt Collection Act would apply to the private debt collection company.[555] Second, taxpayer protections that are statutorily applicable to the IRS would also be made statutorily applicable to the private sector debt collection companies.[556] Third, the private sector debt collection companies would be required to inform taxpayers of the availability of assistance from the Taxpayer Advocate. Fourth, the private sector debt collection companies would not be permitted to subcontract any activities involving taxpayer contact or quality monitoring.

The proposal creates a revolving fund from the amounts collected by the private debt collection companies. The private debt collection companies would be paid out of this fund.

Effective date.–The proposal is effective after the date of enactment.

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providing of other services ... for purposes of tax administration." Accordingly, no amendment to 6103 appears to be necessary to implement the proposal.

[553] The proposal does not explicitly state that the private debt collection company would be permitted to accept payment; under the earlier pilot program, the private debt collection company was not permitted to accept payment directly. Payments were required to be processed by IRS employees.

[554] Although the proposal does not explicitly say so, presumably taxpayers could choose an installment agreement of less than three years.

[555] This is present law.

[556] In some instances, statutory amendments may be required to accomplish this goal. It may be conceptually difficult to apply some of these taxpayer protection provisions to private sector debt collection companies or to their employees. For example, section 1203 of the IRS Restructuring Act contains detailed rules requiring the termination of IRS employees for specified misconduct; the proposal does not specify how those termination rules would apply in this context (including whether they would apply to the private sector debt collection company itself (by, for example, mandating termination of the contract) or to the individual employee of the private sector debt collection company that violated these rules, or to both).

Analysis

One significant policy concern is whether the collection of taxes is so inherently a governmental function that it should not be delegated to the private sector. Similarly, there may be a constitutional issue. Proponents would respond that the actions being delegated to private sector debt collection companies: (1) are limited in scope; (2) are specific and do not permit the exercise of discretionary authority; and (3) do not encompass enforcement actions. Accordingly, proponents believe that neither a policy concern nor a constitutional issue exists.

Another policy issue relates to the method by which private sector debt collection companies will be paid. One alternative is to pay them a flat fee for services rendered. Another alternative is to pay them a variable fee based, at least in part, on their success in actually collecting taxes that are due (by, for example, paying them a percentage of what they collect). This second alternative is generally the method by which the private sector debt collection companies prefer to be paid. Some may question whether it is appropriate to use a payment formula based in whole or in part on the success in collecting taxes that are due.

The use of private debt collectors may free up IRS resources to focus on more recent taxpayer delinquencies where the collection potential is greater. On the other hand, the use of private debt collectors also raises concerns about the ability of the IRS to properly supervise these contractors and protect taxpayer privacy. The IRS has a finite amount of resources to devote to contractor supervision. As the number of private debt collectors increases, the ability of the IRS to closely supervise those collectors and ensure that the collectors are using appropriate safeguards and computer security decreases. As a result, the potential for abuse of taxpayer return information could increase.

Some have argued that the use of private debt collectors will displace government employees from their jobs. The IRS reports that it currently has $75.7 billion in uncollected receivables,[557] owed by over 6.1 million individuals and businesses.[558] Others might respond that these numbers may be so large that the possibility of displacement of government employees may be remote for at least the foreseeable future.

Prior Action

A substantially similar proposal was included in the President's fiscal year 2004 budget proposal.

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[557] This is the dollar value of what the IRS calls the "Potentially Collectible Inventory;" it excludes amounts deemed to be uncollectible or duplicative assessments.

[558] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. Attachment #3.

E. Increase Continuous Levy for Certain Federal Payments

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[559] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[560] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[561]

A continuous levy is applicable to specified Federal payments.[562] This includes any Federal payment for which eligibility is not based on the income and/or assets of a payee. Thus, a Federal payment to a vendor of goods or services to the government is subject to continuous levy. This continuous levy attaches up to 15 percent of any specified payment due the taxpayer.

Description of Proposal

The proposal permits a levy of up to 100 percent of a Federal payment to a vendor of goods or services to the government.

Effective date.–The proposal is effective on the date of enactment.

Analysis

The proposal could provide for more rapid collection of amounts due the IRS by permitting levy on up to the entire Federal payment to vendors of goods or services to the government.[563] On the other hand, the proposal might also discourage vendors who owe amounts to the IRS from selling goods and services to the Federal government, which could deny the government access to essential goods and services. In addition, the proposal could, with respect to some taxpayers, lead to a reduction in total payments of amounts owed to the IRS, in that a levy of 100 percent on a sizeable payment for goods and services to a contactor nearly all of whose business is with the Federal government could lead to the bankruptcy of that Federal contractor, thereby terminating the possibility of further payments to the IRS.

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[559] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

[560] Code sec. 6331.

[561] Code secs. 6335-6343.

[562] Code sec. 6331(h).

[563] *See* Some DOD Contractors Abuse the Federal Tax System with Little Consequence, GAO-04-95, February 2004.

Prior Action

No prior action.

F. Strengthen the Financial Integrity of Unemployment Insurance

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.

Under present law, all States operate experience rating systems. Under these systems an employer's State unemployment tax rate is based on the amount of unemployment benefits paid to the employer's former employees. Generally, the more unemployment benefits paid to former employees, the higher the State unemployment tax rates.

Description of Proposal

The proposal makes changes to the unemployment compensation system to deter employer schemes to artificially lower their State unemployment taxes. Specifically, the proposal requires the States to change their laws to address two types of employer schemes: (1) employers with high experience rates who set up shell companies under common ownership and management and who transfer employees to these shells to take advantage of lower experience rates in the new shell; (2) employers with high experience rates who purchase an separate business with low experience rates and then replace the operations of the purchased business with their business.

In the first case, State law would be required to provide that when an employer transfers its business or a segregable and identifiable part thereof, to another employer, the experience attributable to the transferred business, or part thereof, must be transferred to the acquiring employer, if there is a substantial commonality of ownership and management.

In the second case, State law would be required to prohibit the transfer of the experience rate if the State agency finds that a person, who becomes the employer upon an acquisition, acquired the business or a segregable and identifiable part thereof, solely or primarily for the purpose of attaining a lower rate of contributions.

Finally, the proposal grants the States access to the National Directory of New Hires. This is intended to provide information to the States so that unemployment benefits may be stopped when an individual finds employment.

Effective date.–The proposals would be effective on January 1, 2005.

Analysis

Experience rating under State unemployment systems serves to set an employer's State unemployment taxes at a level commensurate with the amount of unemployment benefits expected to be paid to the former employees of that employer. Schemes to artificially lower an employer's experience rating, and thus the employer's State unemployment taxes, can have a negative impact on the solvency of State unemployment systems. This may result in greater demands on State and Federal funds in order to provide unemployment benefits, higher unemployment taxes for other employers, and reduced unemployment benefits for individuals. Similar fiscal concerns can arise in connection with unemployment benefits improperly paid to individuals who are again employed. The proposal addresses these concerns by transferring an employer's experience rate in certain circumstances and by granting access to current information about individual employment in the National Directory of New Hires.

The proposal to transfer an employer's experience rate if the transfer of a business (or a part thereof) is engaged in solely or primarily for the purpose of attaining a lower rate of unemployment taxes presents issues of the administrability of such a standard. It may be difficult for a State to determine whether the transfer was engaged in solely or primarily for the purpose of attaining a lower rate of unemployment taxes. Criteria for making this determination would help in its administration.

The proposal to share information from the National Directory of New Hires raises concerns as to whether the potential benefit to the administration of unemployment tax benefits outweighs the risk of unauthorized disclosure or use of such information by or through the State unemployment agencies.

Prior Action

No prior action

VII. REAUTHORIZE FUNDING FOR THE HIGHWAY TRUST FUND

A. Deposit Full Amount of Excise Tax Imposed on Gasohol in the Highway Trust Fund

Present Law

An 18.4 cents-per-gallon excise tax is imposed on gasoline. The tax is imposed when the fuel is removed from a refinery unless the removal is to a bulk transportation facility (e.g., removal by pipeline or barge to a registered terminal). In the case of gasoline removed in bulk by registered parties, tax is imposed when the gasoline is removed from the terminal facility, typically by truck (i.e., "breaks bulk"). If gasoline is sold to an unregistered party before it is removed from a terminal, tax is imposed on that sale. When the gasoline subsequently breaks bulk, a second tax is imposed. The payor of the second tax may file a refund claim if it can prove payment of the first tax. The party liable for payment of the gasoline excise tax is called a "position holder," defined as the owner of record inside the refinery or terminal facility.

A 52-cents-per-gallon income tax credit is allowed for ethanol used as a motor fuel (the "alcohol fuels credit"). The benefit of the alcohol fuels tax credit may be claimed as a reduction in excise tax payments when the ethanol is blended with gasoline ("gasohol"). The reduction is based on the amount of ethanol contained in the gasohol. The excise tax benefits apply to gasohol blends of 90 percent gasoline/10 percent ethanol, 92.3 percent gasoline/7.7 percent ethanol, or 94.3 percent gasoline/5.7 percent ethanol. The income tax credit is based on the amount of alcohol contained in the blended fuel.

In general, 18.3 cents per gallon of the gasoline excise tax is deposited in the Highway Trust Fund and 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank Trust Fund (the "LUST" rate). In the case of gasohol with respect to which a reduced excise tax is paid, 2.5 cents per gallon of the reduced tax (2.8 cents in the case of gasoline to be blended) is retained in the General Fund. The balance of the reduced rate (less the LUST rate) is deposited in the Highway Trust Fund.

Description of Proposal

The proposal transfers the 2.5 cents per gallon of excise tax on gasohol (2.8 cents in the case of gasoline to be blended) that currently is retained in the General Fund to the Highway Trust Fund.

Effective date.–The proposal is effective for taxes collected after September 30, 2003.

Analysis

The proposal increases receipts to the Highway Trust Fund by eliminating the General Fund retention of tax on alcohol fuel mixtures. Under present law, only 13.2 cents per gallon is being collected on gasohol (rather than the 18.4 cents per gallon imposed on gasoline) and of that 13.2 cents the Highway Trust Fund receives only 10.6 cents per gallon, because the General Fund retains 2.5 cents and the other .1 cent goes to the Leaking Underground Storage Tank Trust

Fund. Thus, proponents argue the Highway Trust Fund is penalized in two ways. First, the Highway Trust Fund does not get 5.2 cents per gallon due to the reduced rates afforded alcohol fuel mixtures. Second, of the tax that is collected, the Highway Trust Fund receives only a portion, rather than the full amount. Vehicles using renewable fuels can cause as much wear and tear on the highways as vehicles using traditional fuels. As a result, proponents argue that at a minimum, like traditional highway motor fuels, the full amount of tax imposed on alcohol fuel mixtures should be available to the Highway Trust Fund, especially since outlays, even under current law, are projected to exceed receipts.[564]

According to the Congressional Budget Office, this change will provide an additional $4.8 billion dollars to the Highway Trust Fund for the period fiscal year 2004 through fiscal year 2009. Thus, there will be an additional $4.8 billion for highway spending, however, it also means that there may be $4.8 billion less for programs funded out of the General Fund. The proposal does not increase or decrease revenues coming into the Federal Government. It shifts money between government funds. Opponents of the proposal may argue that in times of budget deficits, there are competing funding priorities and the money being transferred from the General Fund to the Highway Trust Fund should be used for other priorities.

Prior Action

A similar provision was in section 2006 of H.R. 6, the Energy Policy Act of 2003, as passed by the Senate on July 31, 2003, and S. 1072, the "Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2004," as passed by Senate on February 12, 2004.

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[564] The Highway Trust Fund is divided into two accounts, the Highway Account and the Mass Transit Account. For fiscal year 2004, the CBO baseline shows that receipts for the Highway Account should be approximately $29.5 billion, while outlays from the account are projected to be approximately $33 billion. Under the baseline, the Highway Account is projected to be in deficit by fiscal year 2008. The Mass Transit Account is projected to go into deficit in fiscal year 2010.

B. Impose Additional Registration Requirements on the Transfer of Tax-Exempt Fuel by Pipeline, Vessel or Barge

Present Law

Registration

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[565] A non assessable penalty for failure to register is $50.[566] A criminal penalty of $5,000, or imprisonment of not more than 5 years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[567] Registrants are not required to display proof of registration.

Bulk transfer exemption

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[568] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") to a terminal or refinery if the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.[569] For example, if a registered vessel or pipeline operator removes fuel in bulk from a registered refiner and transfers the fuel to a registered terminal operator, tax is not imposed on the bulk transfer. For the bulk transfer exemption to apply, the "position holder" with respect to the taxable fuel, i.e., the person shown on the records of the terminal facility as owning the fuel, must be registered with the Secretary.[570]

Present law does not require that every vessel or pipeline operator that transfers fuel as part of a bulk transfer be registered in order for the transfer to be exempt. For example, a registered vessel or pipeline operator may remove fuel from a registered refiner and transfer the fuel to an unregistered vessel or pipeline operator who in turn transfers fuel to a registered terminal operator. The transfer is exempt despite the intermediate transfer by an unregistered person.

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[565] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) & (c)(1).

[566] Sec. 7272(a).

[567] Sec. 7232.

[568] Sec. 4081(a)(1)(A).

[569] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

[570] Treas. Reg. sec. 48.4081-3(d).

In general, the position holder is liable for payment of tax with respect to taxable removals from the terminal rack and bulk transfers not received at an approved terminal or refinery.[571] The refiner is liable for payment of tax with respect to certain taxable removals from the refinery.[572]

Description of Proposal

The proposal requires that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the bulk transfer be registered with the Secretary. Transfer to an unregistered party will subject the transfer to tax. In addition, vessel and barge operators transporting taxable fuel would also be required to display proof of registration in a manner prescribed by the IRS. New penalties would be imposed for failure to comply with registration and display proof of registration requirements. The penalty for failure to register would be $1,000 per day and the penalty for failure to display proof of registration would be $500 per day.

Effective date.–The proposal would apply to bulk transfers (in the case of limits on the exemption) and failures (in the case of new penalties) occurring after October 31, 2004.

Analysis

The proposal limits the exemption for bulk transfers of untaxed fuel to transfers by registered bulk carriers. Proponents of the proposal argue that the opportunities for unregistered bulk carriers to divert the fuel to retailers or end users before the tax is paid will be curtailed under the proposal. They assert that refiners who under present law transfer fuel to unregistered parties as part of an exempt bulk transfer will no longer be willing to do so because of the potential to be liable for tax on the thousands of gallons of fuel that might be involved in a bulk transfer. In addition, requiring the registration and reporting by bulk carriers will enable the IRS to better track bulk transfers of fuel and detect evasion.

The proposal is unclear as to who bears the burden of tax upon transfer to an unregistered party. Some may argue to the extent the proposal would impose tax on the refiner, such imposition of tax is not an appropriate way to curb abuse by unregistered bulk carriers. If the purchaser rather than the refiner contracts with the bulk carrier, some might argue the refiner has no control over whether the chosen carrier is registered, and therefore, the refiner should not bear the risk of being subject to tax. Proponents of the proposal, however, argue that such risk is appropriate, noting that the requirement for the bulk carrier to display proof of registration should provide sufficient notice to the refiner as to whether such a person is registered and therefore entitled to carry tax-free fuel.

Opponents may argue further that a substantial monetary penalty on the unregistered party for carrying untaxed fuel is more appropriate than imposing tax on the fuel. Opponents

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[571] Treas. Reg. sec. 48.4081-2; Treas. Reg. sec. 48.4081-3(d) & (e).

[572] Treas. Reg. sec. 48.4081-3(b).

note that the imposition of tax on the fuel may cause accounting issues related to taxed and untaxed fuel being comingled at the terminal.

The proposal increases penalties for failing to register and requires display of proof of registration. Proponents of the proposal may argue that increasing the penalties for failure to register and display proof of registration will encourage unregistered parties to become registered. On the other hand, if insufficient personnel are available to monitor for violations, such penalties would be ineffective as unregistered persons will doubt the ability of the Government to detect their activities and continue to divert fuel.

Prior Action

On February 12, 2004, the Senate passed a similar proposal as part of S. 1072, the "Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2004". However, the Senate proposal also imposes a penalty on persons transferring fuel to unregistered parties.

C. Repeal Installment Method for Payment of Heavy Highway Vehicle use Tax

Present Law

An annual use tax is imposed on heavy highway vehicles, at the rates below.[573]

Under 55,000 pounds	No tax
55,000-75,000 pounds......................	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers are allowed to pay the tax in installments.[574] Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks.[575] The tax applies only to use before October 1, 2005.

States are required to obtain evidence before issuing tags for a vehicle, that the use tax return has been filed and any tax due with the return has been paid.

Description of Proposal

The proposal eliminates the ability to pay the tax in installments for tax years beginning after June 30, 2004.

Effective date.–The proposal is effective for taxable periods beginning after the date of enactment.

Analysis

The heavy vehicle annual use tax is imposed once per twelve-month period, July 1 through June 30. Taxpayers are allowed to pay the tax (maximum of $550 per truck) in quarterly installments. The "taxpayer" for this tax is the vehicle owner. This results in this tax having the greatest number of persons actually remitting tax of any Highway Trust Fund tax. Further, many taxpayers are liable only for relatively small amounts of tax.

Low compliance by smaller owner-operators and taxable vehicles having base registrations in Canada or Mexico led the Congress to require States to verify with the IRS that the tax has been paid before issuing annual State registrations. In the case of taxpayers that elect

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[573] Sec. 4481.

[574] Sec. 6156.

[575] See generally, sec. 4483.

quarterly installment payments, the IRS has no procedure for ensuring that installments subsequent to the first one actually are paid. Thus, it is possible for taxpayers to receive State registrations when only the first quarterly installment is paid with the return. Similarly, it is possible for taxpayers repeatedly to pay the first quarterly installment and continue to receive State registrations because the IRS has no computerized system for checking past compliance when it issues certificates of payment for the current year. In the case of taxpayers owning only one or a few vehicles, it is not cost effective for the IRS to monitor and enforce compliance.

Eliminating the quarterly installment option would eliminate current opportunities for tax evasion without requiring devotion of IRS resources to non-cost-effective enforcement activities. On the other hand, law-abiding taxpayers will be denied the opportunity to pay their tax liability in installments and opponents might argue that the law should be changed so as to require the IRS to check for past compliance.

Prior Action

On February 12, 2004, the Senate passed a similar proposal as part of S. 1072, the "Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2004".

D. Allow Tax-Exempt Financing for Private Highway Projects and Rail-Truck Transfer Facilities

Present Law

Interest on bonds issued by States or local governments to finance activities of those governmental units is excluded from tax (sec. 103). In addition, interest on certain bonds ("private activity bonds") issued by States or local governments acting as conduits to provide financing for private businesses or individuals is excluded from income if the purpose of the borrowing is specifically approved in the Internal Revenue Code (sec. 141). Examples of approved private activities for which States or local governments may provide tax-exempt financing include transportation facilities (airports, ports, mass commuting facilities, and certain high-speed intercity rail facilities); public works facilities such as water, sewer, and solid waste disposal; and certain social welfare programs such as low-income rental housing, student loans, and mortgage loans to certain first-time homebuyers. High-speed intercity rail facilities eligible for tax-exempt financing include land, rail, and stations (but not rolling stock) for fixed guideway rail transportation of passengers and their baggage using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.

Description of Proposal

Two new categories of exempt facility bonds would be authorized to finance highway facilities and surface freight transfer facilities. Issuance of the bonds would not be subject to the general private activity bond volume cap, but rather would be subject to a separate volume limitation of $15 billion in the aggregate. The Secretary of Transportation would allocate the $15 billion of authority among eligible projects.

Highway facilities eligible for financing under the program would consist of any surface transportation project eligible for Federal assistance under title 23 of the United States Code, or any project for an international bridge or tunnel for which an international entity authorized under Federal or State law is responsible. Surface freight transfer facilities would consist of facilities for the transfer of freight from truck to rail or rail to truck, including any temporary storage facilities directly related to those transfers. Examples of eligible surface freight transfer facilities would include cranes, loading docks and computer-controlled equipment that are integral to such freight transfers. Examples of non-qualifying facilities would include lodging, retail, industrial or manufacturing facilities.

Analysis

Surface freight transfer facilities

Present law provides that private activity bonds may be issued for dock facilities and airport facilities. Dock and airport facilities eligible for private activity bonds include cranes and equipment integral to the loading and unloading of ships and planes and enabling the transfer of that cargo to other modes of transport. The proposal generally would treat rail and truck cargo exchanges comparably to ship to truck or rail exchanges.

Improved cargo transfers improve cargo delivery and reduce transportation costs creating benefits for all consumers. The providers of truck and rail transportation services are private businesses. Generally, if there are cost-reducing efficiencies that can be achieved, a profit opportunity is created and private businesses will make investments to achieve these efficiencies. For example, private railroads invest in facilities and equipment to facilitate the transfer of freight from truck to rail and back to truck to provide so-called "piggyback" service. If the necessary investment to achieve a given level of cost reduction is too great for private business to achieve a reasonable rate of return on investment, the investment usually is not in the public's interest as the benefit to the consuming public is insufficient to justify the investment. However, some observe that current freight handling facilities may promote the consumption of additional fuels and result in pollution, imposing costs not borne directly by consumers in the price of delivered goods. A reduction in pollution may justify subsidies to the investment in freight handling facilities beyond that that would be provided by private business in the absence of such subsidies.

The ability to finance capital and operating costs with tax-exempt bonds may substantially reduce the cost of debt finance. To illustrate, assume the interest rate on taxable debt is 10 percent. If an investor in the 35 percent marginal income tax bracket purchased a taxable debt instrument, his after tax rate of return would be the 10 percent interest less a tax of 35 percent on the interest received for a net return of 6.5 percent. If as an alternative this investor could purchase a tax-exempt bond, all other things such as credit worthiness being equal, he would earn a better after tax return by accepting any tax-exempt yield greater than 6.5 percent.[576] In the market, the yield spread between a tax-exempt bond and comparable taxable bond is determined by the marginal buyer of the bonds; in today's market, yield spreads are generally less than 20 percent.[577] Because the yield spread arises from forgone tax revenue, economists say that tax-exempt finance creates an implicit subsidy to the issuer. However, with many investors in different tax brackets, the loss of Federal receipts is greater than the reduction in the

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[576] More generally, if the investor's marginal tax rate is t and the taxable bond yields r, the investor is indifferent between a tax-exempt yield, r_e, and $(1\text{-}t)r$.

[577] For example, while not comparable in security, market trading recently has priced 30-year U.S. Treasuries (due in 27 years) to have a yield to maturity of approximately 4.92 percent. Prices for an index of long-term tax-exempt bonds have produced a yield to maturity of approximately 4.43 percent. See, *The Bond Buyer,* 347, February 17, 2004, p. 40. Again ignoring differences in risk or other non-tax characteristics of the securities, the yield spread implies that an investor with a marginal tax rate of 10 percent would be indifferent between the Treasury bond and the average high-quality tax-exempt bond. Thus, under present market conditions, yield spreads on long-term bonds are so narrow that almost all taxpayers investing in those instruments should prefer tax-exempt bonds. Viewed another way, almost the entire Federal subsidy to these bonds goes to bondholders (rather than State or local government issuers, or the private persons repaying the debt in the case of private activity bonds) under these market conditions.

tax-exempt issuers' interest saving.[578] The difference accrues to investors in tax brackets higher than those that would be implied by the yield spread between taxable and tax exempt bonds.

International bridges and tunnels

The proposal permits private activity bonds to be issued for international bridges or tunnels for which an international entity authorized under Federal or State law is responsible. Proponents of the proposal might argue that a private entity might be able to more effectively and efficiently manage such structures. In addition, having a private entity own the structure may provide additional capital for maintenance and upkeep. On the other hand, opponents might argue that the benefit from such international projects does not justify the decrease in Federal revenues that would result from the proposal.

Prior Action

On February 12, 2004, the Senate passed a similar proposal as part of S. 1072, the "Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2004".

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[578] The Federal income tax has graduated marginal tax rates. Thus, $100 of interest income forgone to a taxpayer in the 33-percent bracket costs the Federal Government $33, while the same amount of interest income forgone to a taxpayer in the 25-percent bracket costs the Federal Government $25. If a taxpayer in the 25-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 33-percent bracket will find it even more profitable. This conclusion implies that the Federal Government will lose more in revenue than the tax-exempt issuer gains in reduced interest payments.

VIII. EXPIRING PROVISIONS

A. Extend Alternative Minimum Tax Relief for Individuals

Present Law

The alternative minimum tax ("AMT") 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 an exemption amount that phases out 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) $58,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $40,250 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $29,000 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing separate returns; 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.

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,[579] 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 before 2004, 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 2003, 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.

Description of Proposal

The proposal extends the higher individual AMT exemption amounts ($58,000, $40,250, and $29,000).

[579] A portion of the child credit may be refundable.

The proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective date.–The proposal is effective for taxable years beginning in 2004 and 2005.

Analysis

Allowing the nonrefundable personal credits to offset the regular tax and alternative minimum tax, and increasing the exemption amounts 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.[580]

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 does not undermine the policy of the individual alternative minimum tax and promotes the important social policies underlying each of the credits.

Congress also has temporarily increased the exemption amount in recent years to limit the impact of the AMT. For example, the Jobs and Growth Tax Relief Act Reconciliation Act of 2003 increased the AMT exemption amounts for taxable years beginning in 2003 and 2004.

The following examples compare the effect of not extending minimum tax relief with the effect of the proposal extending minimum tax relief:

Example 1.–Assume in 2004, a married couple has an adjusted gross income of $80,000, 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 a combined $3,000 HOPE Scholarship credit. The couple's net tax liability (without and with an extension) is shown in Table 13.

[580] For a recommendation that the repeal of the individual alternative minimum tax will result in significant tax simplification, see *Study of the Overall State of the Federal Tax System and Recommendations Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, p. 2.

Table 13.–Comparison of Individual Tax Liability Without Extension of Rules and With Extension, 2004

	Without Extension	Proposal (With Extension)
Adjusted gross income	$80,000	$80,000
Less standard deduction	9,700	9,700
Less personal exemptions (6 @ $3,100)	18,600	18,600
Taxable income	51,700	51,700
Regular tax	7,040	7,040
Tentative minimum tax	5,720	5,720
HOPE Scholarship credit before limitation	3,000	3,000
Tentative minimum tax limitation:		
Regular tax	7,040	7,040
Less tentative minimum tax	5,720	5,720
Limitation	1,320	7,040
HOPE Scholarship credit	1,320	3,000
Child tax credit	2,000	2,000
Net tax	3,720	2,040
Net tax reduction		1,680

Example 2.–Assume in 2005, a married couple has an adjusted gross income of $100,000, they do not itemize deductions, and they have two dependent children who are eligible for the child tax credit. The couple's net tax liability with and without an extension of the AMT exemption amount, are computed as shown in Table 14.

Table 14.–Comparison of Individual Tax Liability With and Without Extension of Exemption Amounts, 2005[581]

	Without Extension	Proposal (With Extension)
Adjusted gross income	$100,000	$100,000
Less standard deduction[582]	9,900	9,900
Less personal exemptions (4 @ $3,150)	12,600	12,600
Taxable income	77,500	77,500
Regular tax	12,738	12,738
AMT exemption amount	45,000	58,000
AMTI less exemption amount	55,000	42,000
Tentative minimum tax	14,300	10,920
Alternative minimum tax	1,562	0
Child tax credit	2,000	2,000
Net tax	12,300	10,738
Net tax reduction		1,562

Prior Action

A substantially similar proposal was included in the President's fiscal year 2004 budget proposal.

[581] The example assumes all extensions recommended by the President's proposal, except that the AMT exemption amount is assumed not extended in the first column of the table.

[582] This example assumes the taxpayers claim the standard deduction and have no itemized deductions (other than taxes and miscellaneous itemized deductions). Taxpayers subject to the AMT may elect to itemize deductions even though the total amount of the itemized deductions for purposes of the regular tax is less than the standard deduction. Taxpayers may not use the standard deduction for the regular tax and use itemized deductions for the AMT.

B. Permanently Extend the Research and Experimentation ("R&E") 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 expenses for a taxable year exceed 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.[583]

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[583] 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.

A 20-percent research tax credit also applies to the excess of (1) 100 percent of corporate cash expenses (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 expenses for the current taxable year exceed its base amount. The base amount for the current year generally is 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 expenses 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 expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base

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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.

percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[584]

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenses.

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)). Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses 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 expenses 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.[585] 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 incremental 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 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

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[584] 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 expenses. 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 expenses 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 expenses 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)).

[585] Sec. 41(c)(4).

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 expenses

Qualified research expenses 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 or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[586]

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 substantially all of the activities of which must constitute elements of a process of experimentation for 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: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control (sec. 41(d)(4)). Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a

[586] 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. Sec. 41(b)(3)(C).

useful life extending beyond the current year must be capitalized.[587] 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 (Sec. 280C(c)). Taxpayers may 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 is made permanent.

Effective date.–The proposal is effective on the date of enactment.

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.[588] 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. However, 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.[589] Nevertheless, even if there were agreement that additional subsidies for research

[587] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

[588] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

[589] See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. 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.

are warranted as a general matter, misallocation of research dollars across competing sectors of the economy could diminish economic efficiency. It is difficult to determine whether, at the present levels and allocation of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency.

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 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.

Scope of research activities in the United States and abroad

In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.8 percent of gross domestic product in 2002.[590] This rate of expenditure on research and development exceeds that of the European Union and the average of all countries that are members of the Organisation for Economic Co-operation and Development ("OECD"), but is less than that of Japan. See Figure 1, below. In 2001, expenditures on research and development in the United States represented 43.7 percent of all expenditures on research and development undertaken by OECD countries, were 55 percent greater than the total expenditures on research and development undertaken in the European Union, and were more than two and one half times such expenditures in Japan.[591] Expenditures on research and development in the United States have grown at an average real rate of 5.4 percent over the period 1995-2001. This rate of growth has exceeded that of Japan (2.8 percent), Germany (3.3 percent), France (2.4 percent for the period 1997-1999), Italy (2.7 percent for the period 1997-2000), and the United Kingdom, (2.3 percent), but is less than that of Canada (5.6 percent), Ireland (7.5 percent), and Spain (6.5 percent).[592]

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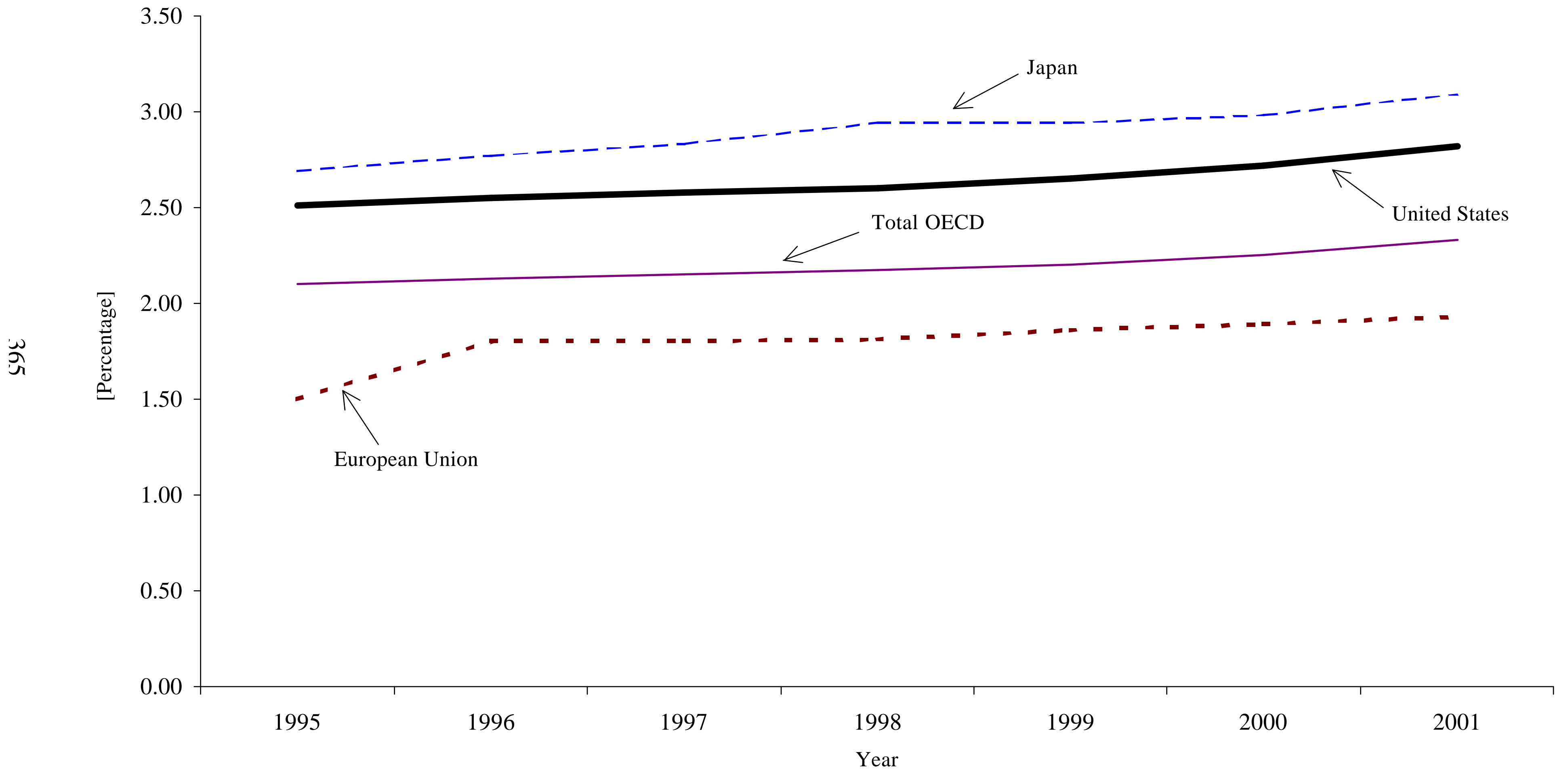
[590] Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Scoreboard, 2003*, (Paris: Organisation of Economid Co-operation and Development), 2003. The OECD, measuring in real 1995 dollars, calculates that the United States spent approximately $253 billion on research and development in 2001.

[591] *Ibid.*

[592] *Ibid.* The OECD calculates the annual real rate of growth of expenditures on research and development for the period 1995-2001 in the European Union and in all OECD countries at 3.7 percent and 4.7 percent, respectively.

Figure 1.--Gross Domestic Expenditure on R&D as a Percentage of GDP, United States, Japan, the European Union, and the OECD, 1995-2001



The scope of present-law tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit was estimated to be $5.1 billion for 2003. The related tax expenditure for expensing of research and development expenditures was estimated to be $3.8 billion for 2003 growing to $6.2 billion for 2007.[593] As noted above, the Federal Government also directly subsidizes research activities. For example, in fiscal 2003 the National Science Foundation made $3.8 billion in grants, subsidies, and contributions to research activities, the Department of Defense financed $10.6 billion in basic research, applied research, and advanced technology development, and the Department of Energy financed $1.0 billion in research in high energy physics, $1.0 billion in basic research in the sciences, $0.5 billion in biological and environmental research, and $166 million for research in advance scientific computing.[594]

Table 15 and Table 16 present data for 2001 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. In 2001, more than 15,000 taxpayers claimed more than $6.5 billion in research tax credits.[595] Taxpayers whose primary activity is manufacturing claimed nearly two thirds of the research tax credits claimed. Firms with assets of $50 million or more claimed more than 85 percent of the credits claimed. Nevertheless, as Table 16 documents, a large number of small firms are engaged in research and were able to claim the research tax credit.

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[593] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007* (JCS-5-03), December 19, 2002, p. 18. Projections for 2004 are not presented in the text because with the scheduled expiration of the research and experimentation tax credit, such a projection would not reflect a full year of research activity.

[594] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005*, Appendix, pp.1052, 292-297, and 388-391.

[595] The $6.5 billion figure reported for 2001 is not directly comparable to the $5.1 billion tax expenditure estimate for 2003 reported in the preceding paragraph. The tax expenditure estimate accounts for the present-law requirement that deductions for research expenditures be reduced by research credits claimed.

Table 15.–Percentage Distribution of Firms Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2001

Industry	Percent of Corporations Claiming Credit	Percent of Total R & E Credit
Manufacturing	42.26	65.96
Information	18.28	15.60
Professional, Scientific, and Technical Services	25.97	10.39
Wholesale Trade	4.85	2.37
Finance and Insurance	0.76	1.90
Holding Companies	0.68	1.27
Retail Trade	1.26	0.63
Administrative and Support and Waste Management and Remediation Services	0.44	0.42
Health Care and Social Services	0.88	0.34
Utilities	2.74	0.16
Mining	0.30	0.15
Real Estate and Rental and Leasing	0.53	0.07
Agriculture, Forestry, Fishing and Hunting	0.42	0.05
Transportation and Warehousing	(1)	(1)
Construction	(1)	(1)
Arts, Entertainment, and Recreation	(1)	(1)
Accommodation and Food Services	(1)	(1)
Educational Services	(1)	(1)
Other Services	(1)	(1)
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 16.–Percentage Distribution of Firms Claiming Research Tax Credit and of Amount of Credit Claimed by Firm Size, 2001

Asset Size ($)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	2.56	0.82
1 to 100,000	16.15	0.22
100,000 to 250,000	4.61	0.15
250,000 to 500,000	3.20	0.34
500,000 to 1 million	7.69	0.54
1 to 10 million	33.66	5.05
10 to 50 million	17.09	7.69
50 million and more	15.05	85.19

Source: JCT calculations from Internal Revenue Service, Statistics of Income data.

Flat or 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 (i.e., a flat credit). 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 a present value of $95. Suppose that the research 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 but 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. 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. 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 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 base 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.

<u>The responsiveness of research expenditures to tax incentives</u>

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 price 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.[596] 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.[597]

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[596] 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.

[597] 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

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.[598]

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.[599] Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

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otherwise--so called marginal research expenditures--need be subject to the credit to have a positive incentive effect.

[598] 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. The negative coefficient in the text reflects that a decrease in price results in an increase in research expenditures. Often, such elasticities are reported without the negative coefficient, it being understood that there is an inverse relationship between changes in the "price" of research and changes in research expenditures.

[599] 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.

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

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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 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*, vol. 88, May, 1998, pp. 298-302.

present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.[600]

Under present law, firms with research expenditures substantially in excess of their base amount may be subject to the 50-percent base amount limitation. In general, although these firms receive the largest amount of credit when measured as a percentage of their total qualified research expenses, their marginal effective rate of credit is exactly one half of the statutory credit rate of 20 percent (i.e., firms subject to 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 yield estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, i.e., between 12 and 15 percent.[601]

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 drift 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 amount 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

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[600] 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.

[601] 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.

section 174.[602] 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.

> 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.[603]

<u>Prior Action</u>

The President's fiscal year 2004 and 2003 budget proposals contained an identical provision.

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[602] 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.

[603] David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, vol. 50, September 1997, pp. 487-493.

C. Repeal Rules Requiring Reduction of Deductions for Mutual Life Insurance Companies

Present Law

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins. Under present and prior law, the differential earnings rate cannot be a negative number.

A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

A recomputation or "true-up" in the succeeding year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

Present law provides a temporary zero rate for both the differential earnings rate and recomputed differential earnings rate ("true-up") for a life insurance company's taxable years beginning in 2001, 2002, or 2003.

Description of Proposal

The proposal repeals the present-law provision requiring a mutual life insurance company to reduce its deductions by the differential earnings amount (sec. 809).

Effective date.–The proposal is effective for taxable years beginning in 2004.

Analysis

Complexity issues

Advocates of the proposal may argue that repealing the present-law rule requiring a mutual life insurance company to reduce its deductions by the differential earnings amount simplifies the tax law. It can be argued that the present-law rule adds complexity to the tax law in several respects. The rule imposes an additional set of calculations in two separate taxable years of the affected insurance companies. Part of the complexity of these rules arises from the fact that a portion of the calculation of the mutual companies' disallowed deduction is based on earnings rates of other companies, the 50 largest stock companies. In addition, some mutual companies may be able to manipulate these rules by planning capital gains realizations. Changes in the composition of the life insurance industry, including demutualizations and other transactions that minimize the impact of the rule, have had the effect of disrupting the functioning of the rule (which was based on the assumption of a particular balance between the stock segment and the mutual segment of the life insurance industry).

On the other hand, it could be argued that the present-law rule applies to a shrinking group of mutual life insurance companies that are familiar with the rule because it has been in the law since 1984. Further, the differential earnings rate has been zero for most years in the recent past (before the enactment of the temporary zero rate for 2001, 2002, and 2003), so the rule has had limited application. Thus, little simplification would be gained by repealing the rule.

Policy issues

Advocates of the proposal could argue that repealing the present-law rule is not inconsistent with the tax policy goal of accurate income measurement. Although a purpose of the present-law rule may have been to treat a portion of mutual policyholder dividends as a return on equity (like dividends to shareholders of a stock company), the rule is not currently carrying out this purpose. The rule does not accurately measure the portion of policyholder dividends that are conceptually equivalent to shareholder dividends, because the application of the average earnings rate of the 50 largest stock companies no longer produces the right result due to changes in the composition of the life insurance industry. Further, flaws in the mechanisms of the rule result in an uneven effect of the rule among mutual companies. Moreover, if a goal of the present-law provision was to balance the tax burden as between the stock and mutual segments of the life insurance industry to parallel their respective share of the life insurance business, it can be argued that the respective shares of the business have changed since enactment of the provision. Thus, the provision is no longer appropriate or needed to achieve this goal.

Opponents of the proposal may argue that retaining the present-law rule (even though it may be flawed) is appropriate until a replacement rule can be developed to carry out the goal of preventing deduction of returns on mutual company equity. Opponents of the proposal might alternatively argue that extending the temporary zero-rate rule under the present-law provision

would be more appropriate than repeal of the present-law rule altogether. This approach would permit Congress to monitor the level of and treatment of policyholder dividends, as well as the segment balance within the industry, to ascertain whether either modifications to the present-law rule or repeal would be more appropriate.

Prior Action

An identical proposal was included in the President's fiscal year 2004 budget proposals.

D. Permanently Extend and Expand Disclosure of Tax Return Information for Administration of Student Loans

Present Law

Income-contingent loan verification program

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code.[604] An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan.[605] The Department of Education disclosure authority is scheduled to expire after December 31, 2004.[606]

An exception to the general rule prohibiting disclosure is also provided for the disclosure of returns and return information to a designee of the taxpayer.[607] Because the Department of Education utilizes contractors for the income-contingent loan verification program, the Department of Education obtains taxpayer information by consent under section 6103(c), rather than under the specific exception.[608] The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[609]

Verifying financial aid applications

The Higher Education Act of 1998 ("Higher Education Act") authorized the Department of Education to confirm with the Internal Revenue Service four discrete items of return information for the purposes of verifying of student aid applications.[610] The Higher Education Act, however, did not amend the Code to permit disclosure for this purpose. Therefore, the disclosure provided by the Higher Education Act may not be made unless the taxpayer consents to the disclosure under section 6103(c).

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[604] Sec. 6103.

[605] Sec. 6103(l)(13).

[606] Pub. L. No. 108-89, sec. 201 (2003).

[607] Sec. 6103(c).

[608] Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions*, *Volume I: Study of General Provisions* (October 2000) at 91.

[609] Department of Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (February 2003), p. 133.

[610] Pub. L. No. 105-244, sec. 483 (1998).

The financial aid application is submitted to the Department of Education and is then given to a contractor for processing. Based on the information given, the contractor calculates an expected family contribution that determines the amount of aid a student will receive. All Department of Education financial aid is disbursed directly through schools or various lenders.

The Department of Education requires schools to verify the financial aid information of 30 percent of the applicants. The applicants must furnish a copy of their tax returns. The applicants are not required to obtain copies of tax returns from the IRS or to produce certified copies. If the information reflected on the student's copy of the tax return does not match the information on the financial aid application, the school requires corrective action to be taken before a student receives the appropriate aid.

The Office of Inspector General of the Department of Education has reported that, because many applicants are reporting incorrect information on their financial aid applications, erroneous overpayments of Federal Pell grants have resulted.

Overpayments of Pell grants and defaulted student loans

For purposes of locating a taxpayer to collect an overpayment of a Federal Pell grant or to collect payments on a defaulted loan, the Internal Revenue Service may disclose the taxpayer's mailing address to the Department of Education.[611] To assist in locating the defaulting taxpayer, the Department of Education may redisclose the mailing address to the officers, employees and agents of certain lenders, States, nonprofit agencies, and educational institutions whose duties relate to the collection of student loans.[612]

Safeguard procedures and recordkeeping

Federal and State agencies that receive returns and return information are required to maintain a standardized system of permanent records on the use and disclosure of that information.[613] Maintaining such records is a prerequisite to obtaining and continuing to obtain returns and return information. Such agencies must also establish procedures satisfactory to the IRS for safeguarding the information it receives. The IRS must also file annual reports with the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Taxation regarding procedures and safeguards followed by recipients of return and return information.[614]

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[611] Sec. 6103(m)(4).

[612] *Id.*

[613] Sec. 6103(p)(4).

[614] Sec. 6103(p)(5).

Description of Proposal

The proposal allows the disclosure to the Department of Education and its contractors of the adjusted gross income, filing status, total earnings from employment, Federal income tax liability, type of return filed and taxpayer identity information for the financial aid applicant or of the applicant's parents (if the applicant is a dependent) or spouse (if married). Pursuant to the proposal, the Department of Education could use the information not only for establishing a loan repayment amount but also for verifying items reported by student financial aid applicants and their parents.

The proposal allows the Department of Education to use contractors to process the information disclosed to the Department of Education, eliminating the need for consents. It is understood that the proposal imposes the present-law safeguards applicable to disclosures to Federal and State agencies on disclosures to the Department of Education and its contractors.

Effective date.–The proposal is effective with respect to disclosures made after the date of enactment.

Analysis

Contractors

The proposal permits the disclosure of a taxpayer's return information to contractors and agents of the Department of Education, not just to Department of Education employees. Some might argue that the use of contractors significantly expands the risk of unauthorized disclosure, particularly when return information is used by a contractor outside of the recipient agency. The volume of taxpayer information involved under this proposal and the disclosure of millions of taxpayer records, significantly contributes to the risk of unauthorized disclosure. On the other hand, some might argue that it is appropriate to permit the disclosure of otherwise confidential tax information to contractors to ensure the correctness of Federal student aid.

Opponents of the proposal may argue that it is not clear that the Internal Revenue Service has the resources and computer specialists to implement and enforce the safeguards that the proposal imposes. However, proponents of the proposal argue that the proposal alleviates some of the burden on the Internal Revenue Service by requiring the Department of Education to monitor its contractors as a supplement to the safeguard reviews conducted by the Internal Revenue Service.

Burdens on IRS

In general, the proposal eases the burden on the financial aid applicant because the applicant will not be required to produce copies of their tax returns for verification of their financial aid applications. The proposal arguably provides simplification for the schools as well, because the schools will no longer be required to match the information of 30 percent of its applicants. On the other hand, the proposal tends to increase complexity for the Internal Revenue Service by requiring it to resolve discrepancies between tax information and income data on the financial aid application if the applicant is unable to resolve the discrepancy with the school.

Income contingent loan verification program

Currently the Department of Education uses consents to obtain tax information for purposes of its income contingent loan verification program, and does not rely on the statutory authority to receive that information without consent. The IRS processes over 100,000 consents for this program. Some might argue that since the specific statutory authority is not being used, it should not be extended.

Verifying financial aid applications

Congress has expressed a concern about the increasing number of requests for the disclosure of confidential tax information for nontax purposes and the effect of such disclosures on voluntary taxpayer compliance.[615] Some might argue that consensual disclosure of return information, in which the taxpayer knowingly consents to the disclosure of his or her return information ("consents"), is less likely to adversely impact taxpayer compliance than adding a nonconsensual provision for the disclosure of taxpayer information. Since the Internal Revenue Service is already processing consents for the Department of Education, some would argue that the current practice simply could be extended to financial aid applications.[616] On the other hand, some might argue that because present law does not impose restrictions on redisclosure of return information obtained by consent, the proposal, which imposes such restrictions, would be preferable.

Critics might argue that the disclosure of sensitive return information of millions[617] of taxpayers to identify the abuse of a few does not strike the appropriate balance between the need to know and the right to privacy. On the other hand, some might argue that since this financial information is already required to be submitted as part of the financial aid form, the infringement on taxpayer privacy is minimal.

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[615] S. Prt. No. 103-37 at 54 (1993).

[616] In its study on the disclosure of return information, the Department of Treasury noted: "The burden of processing this number of consents obviously would be reduced if the consents were executed and transmitted electronically. Accordingly, the Department of Education has asked to be included in the TDS program." Department of Treasury, *Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (2000) at 92.

[617] The Department of Education seeks access to the return information of approximately 15 million taxpayers each year. The Department of Education receives approximately 10 million applications for student financial assistance each year. Because roughly half of the applicants are dependents, income information is needed for both the student and his or her parents. Thus, verification under this provision could apply to over 15 million taxpayers each year. It is not clear what percentage of applicants submit fraudulent financial aid applications. *Id.*

Prior Action

Similar proposals were contained in the President's fiscal year 2003 and 2004 budget proposals.

E. Extend and Modify the Work Opportunity Tax Credit and Welfare-to-Work Tax Credit

Present Law

Work opportunity tax credit

Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families 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.

A qualified ex-felon is an individual certified as: (1) haven been convicted of a felony under State or Federal law; (2) being a member of an economically disadvantaged family; and (3) having a hiring date within one year of release from prison or conviction.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) 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. Therefore, 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).

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Welfare-to-work tax credit

Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. 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 such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if they are hired within 2 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 2 years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax credit which includes simply cash wages, the definition of wages for the welfare-to-work tax credit includes cash wages paid to an employee plus amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, 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.

Calculation of the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients during the first two years of employment. The maximum credit is 35 percent of the first $10,000 of qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Qualified first-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning with the day the individual began work for the employer. Qualified second-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning immediately after the first year of that individual's employment for the employer. The maximum credit is $8,500 per qualified employee.

Minimum employment period

No credit is allowed for qualified wages paid to a member of the targeted group unless they work at least 400 hours or 180 days in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The welfare-to-work tax credit incorporates directly or by reference many of these other rules contained on the work opportunity tax credit.

Description of Proposal

Combined credit

The proposal combines the work opportunity and welfare-to-work tax credits and extends the combined credit for two years.

Targeted groups eligible for the combined credit

The combined credit is available on an elective basis for employers hiring individuals from one or more of all nine targeted groups. The welfare-to-work credit/long-term family assistance recipient is the ninth targeted group.

The proposal repeals the requirement that a qualified ex-felon be an individual certified as a member of an economically disadvantaged family.

Qualified wages

Qualified first-year wages for the eight WOTC categories remain capped at $6,000 ($3,000 for qualified summer youth employees). No credit is allowed for second-year wages. In the case of long-term family assistance recipients the cap is $10,000 for both qualified first-year wages and qualified second-year wages. For all targeted groups, the employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

First-year wages.–For the eight WOTC categories, the credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) 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. Therefore, the maximum credit per employee for members of any of the eight WOTC targeted groups generally 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 remains $1,200 (40 percent of the first $3,000 of qualified first-year wages). For the welfare-to-work/long-term family assistance recipients, the maximum credit equals $4,000 per employee (40 percent of $10,000 of wages).

Second year wages.–In the case of long-term family assistance recipients the maximum credit is $5,000 (50 percent of the first $10,000 of qualified second-year wages).

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

Coordination is no longer be necessary once the two credits are combined

Effective date.–The proposal is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2003 and before January 1, 2006.

Analysis

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 will 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.[618]

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

[618] 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).

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.

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.[619] 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

[619] 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.

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").[620]

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 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.[621]

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

[620] *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.

[621] 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.

individual.[622] In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

Retroactive effective date

In the case of tax benefits that are intended to create an incentive for particular taxpayer behavior, some may argue that a retroactive extension rewards behavior that occurred without the incentive and, therefore, is unnecessary. Others may respond that taxpayers have relied on Congressional assurances of retroactive extension or past retroactive extensions to engage in such behavior.

Prior Action

Separate proposals to extend the two credits without combining them were included in the President's fiscal year 2002 and 2003 budget proposals.[623] A similar proposal was included in the President's fiscal year 2004 budget proposals.

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[622] 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.

[623] Pub. L. No. 107-147, "The Job Creation and Worker Assistance Act of 2002," extended the credit for two years.

F. Extend District of Columbia Enterprise Zone

Present Law

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. The D.C. Zone designation remains in effect for the period from January 1, 1998, through December 31, 2003.[624] In addition to the tax incentives available with respect to a Round I empowerment zone (including a wage credit), the D.C. Zone also has a zero-percent capital gains rate that applies to gain from the sale of certain qualified D.C. Zone assets acquired after December 31, 1997, and held for more than five years.

With respect to the tax-exempt financing incentives, the D.C. Zone generally is treated like a Round I empowerment zone;[625] therefore, the issuance of such bonds is subject to the District of Columbia's annual private activity bond volume limitation. However, the aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed $15 million.[626]

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[624] The Omnibus Budget Reconciliation Act of 1993 authorized the designation of a total of nine empowerment zones and 95 enterprise communities to provide tax incentives for businesses to locate within certain geographic areas designated by the Secretaries of Housing and Urban Development ("HUD") and Agriculture. Portions of the District of Columbia were designated an enterprise community in 1994 and thus became eligible to issue tax-exempt enterprise zone facility bonds.

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the D.C. Zone. The census tracts that compose the D.C. Enterprise Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (*i.e.*, portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Zone designation was scheduled to expire on December 31, 2002.

The Community Renewal Tax Relief Act of 2000 extended the designation of the D.C. Zone for one additional year, through December 31, 2003.

[625] Portions of the District of Columbia were designated as an enterprise community under section 1391 in 1994. Accordingly, the District of Columbia was entitled to issue tax-exempt enterprise zone facility bonds.

[626] Sec. 1400A(a).

Description of Proposal

The proposal extends the D.C. Zone designation for two years, through December 31, 2005. The capital gain eligible for the zero-percent capital gains is expanded to include gain attributable to the period from January 1, 2009 through December 31, 2010.

Effective date.–The proposal is effective from December 31, 2003.

Analysis

A temporary extension of the D.C. Zone tax incentives will eliminate (for two years) the uncertainty faced by businesses and employers within the designated area regarding the tax incentives that would affect any economic decision on future expansion or investment opportunities. Some argue, however, that either the temporary expiration of the tax incentives or the permanent extension of the tax incentives would provide reduced uncertainty permanently.

The additional extension also provides additional time to evaluate the effectiveness of the incentive. On the other hand, some might argue that since the D.C. Zone designation has been in place since August 1997, a permanent decision could be made based on the experience during that time period.

The proposal is designed to encourage business investment in the D.C. Zone by extending for two years the tax incentives that are available to businesses within this area. According to the Treasury Department, certain portions of the District of Columbia are still characterized by high levels of poverty, unemployment and other indicators of economic distress. An extension of the D.C. Zone incentives would encourage the continued economic redevelopment of these areas.

In the case of tax benefits that are intended to create an incentive for particular taxpayer behavior, some may argue that a retroactive extension rewards behavior that occurred without the incentive and, therefore, is unnecessary. Others may respond that taxpayers have relied on Congressional assurances of retroactive extension or past retroactive extensions to engage in such behavior.

Prior Action

A similar proposal was included in the President's fiscal year 2004 budget proposals.

G. Extend District of Columbia Homebuyer Tax Credit

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2003.[627]

Description of Proposal

The proposal extends the first-time homebuyer credit for two years, through December 31, 2005.

Effective date.–The proposal is effective for residences purchased after December 31, 2003.

Analysis

A temporary extension provides some stability for potential homebuyers and the housing market in the District of Columbia. The additional extension also provides additional time to evaluate the effectiveness of the incentive. On the other hand, some might argue that since the incentive has been in place since August 1997, a permanent decision could be made based on the experience during that time period.

The proposal is designed to encourage greater homeownership in the District of Columbia by extending for two years the tax credit for first-time homebuyers. According to the Treasury Department, the homeownership rate in the District of Columbia is significantly below the rate for the neighboring States and the nation as a whole. Extending the credit enhances the District of Columbia's ability to attract new homeowners and establish a stable residential base.

In the case of tax benefits that are intended to create an incentive for particular taxpayer behavior, some may argue that a retroactive extension rewards behavior that occurred without the incentive and, therefore, is unnecessary. Others may respond that taxpayers have relied on

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[627] The District of Columbia first-time homebuyer credit was enacted as part of the Taxpayer Relief Act of 1997, and was scheduled to expire on December 31, 2000. The Tax Relief Extension Act of 1999 extended the first-time homebuyer credit for one year, through December 31, 2000. The Community Renewal Tax Relief Act of 2000 extended the first-time homebuyer credit for two additional years, through December 31, 2003.

Congressional assurances of retroactive extension or past retroactive extensions to engage in such behavior.

Prior Action

A similar proposal was included in the President's fiscal year 2004 budget proposals.

H. Extend Authority to Issue Qualified Zone Academy Bonds

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). An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt (sec. 149(e)). Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

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 2003. 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

zone or 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.

Description of Proposal

The proposal authorizes issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2004 and 2005. For qualified zone academy bonds issued after the date of enactment, the proposal requires issuers to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

Effective date.–The provision is effective generally for obligations issued after the date of enactment.

Analysis

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.

The proposal's reporting requirements may assist in the monitoring of the use of these bonds. On the other hand, it will add to complexity in that it imposes a requirement not previously applied to qualified zone academy bonds. In addition, the proposal increases the paperwork burden on issuers in that forms must be completed and filed with the IRS.

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.[628] 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.[629] 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

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[628] 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.

[629] 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.

Government, further risk is imposed on the investor. These information costs and other risks 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

Similar proposals were included in the President's fiscal year 2003 and 2004 budget proposals.

I. Extend Deduction for Corporate Donations of Computer Technology

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[630]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[631] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.[632] The original use of the property must be by the donor or the donee,[633] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a

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[630] Sec. 170(e)(1).

[631] Secs. 170(e)(4) and 170(e)(6).

[632] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[633] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.[634]

Description of Proposal

The proposal extends the enhanced deduction to apply to donations made in taxable years beginning after December 31, 2003 and to donations made in taxable years beginning before January 1, 2006.

Effective date.–The proposal is effective on the date of enactment.

Analysis

In the absence of the enhanced deduction of present law, if the taxpayer were to dispose of excess inventory by dumping unneeded computer equipment in a garbage dumpster, the taxpayer generally could claim the purchase price of the inventory (the taxpayer's basis in the property) as an expense against his or her gross income. In the absence of the enhanced deduction of present law, if the taxpayer were to donate the unneeded computer equipment to a school or library, the taxpayer generally would be able to claim a charitable deduction equal to the taxpayer's basis in the computer equipment (subject to certain limit on charitable contributions). From the perspective of the taxpayer's profit motive, the taxpayer would be indifferent between donating the computer equipment and dumping the computer equipment in a garbage dumpster. If the taxpayer must incur cost to deliver the computer equipment to the school or library, the taxpayer would not find it in his or her financial interest to donate the computer equipment to the school or library. The enhanced deduction for computer equipment and software is intended to give businesses greater incentive to contribute computer equipment and software to educational organizations and public libraries.

Proponents argue that present law helps accelerate the nationwide adoption of computer technology in education and helps avail more individuals internet access through their local public library. Proponents argue that more time is needed to achieve higher levels of computer access and that it is appropriate to extend the present-law enhanced deduction to help attain this outcome. However, some argue that if the intended policy were to promote adoption of computer technology in education and internet access via public libraries, 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.

The proposal, as does present law, creates certain complexities for the taxpayer and the Internal Revenue Service. The enhanced deduction is allowed to the donor only for equipment that the donee does not trade or sell. Generally, once the equipment is in the hands of the donee it is difficult for the donor to monitor the use of the equipment. Likewise, it is difficult for the Internal Revenue Service to ascertain whether a claim for an enhanced deduction would be valid. Also, the proposal, as does present law, predicates the enhanced deduction on an ascertainable

[634] Sec. 170(e)(6)(C).

fair market value of the computer technology.[635] With the rapid advances in the field, such determinations are difficult at times. However, third-party tracking of prices for used computer equipment do exist. In this regard, the limitation to equipment less than three years old may aid taxpayer compliance and Internal Revenue Service administration.

Taxpayers who contribute computer equipment from inventory must consider multiple factors to ensure that they deduct the permitted amount (and no more than the permitted amount) with respect to contributed equipment. Taxpayers who are required to maintain inventories for such items must consider the fair market value of the contributed equipment, the basis of the equipment (and twice the basis of the equipment), and the resulting income that would be realized if the equipment were sold, and coordinate the resulting contribution deduction with the determination of cost of goods sold.[636]

Prior Action

An identical proposal was part of the President's fiscal year 2004 budget.

The "CARE Act of 2003," S. 476, as passed by the Senate on April 9, 2003, contains a similar proposal that would modify and extend the enhanced deduction beyond the present-law expiration date to contributions made during any taxable year beginning before January 1, 2006.

The "Charitable Giving Act of 2003," H.R. 7 as passed by the House of Representatives on September 17, 2003, contains a proposal that would make the present-law deduction for computer equipment permanent.

H.R. 3521, the "Tax Relief Extension Act of 2003," as passed by the House of Representatives on November 20, 2003, would extend the present-law deduction for computer equipment through December 31, 2004.

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[635] The enhanced deduction is equal to the lesser of basis plus one-half of the item's appreciated value (that is, one-half basis plus one-half fair market value) or two times basis. The two times basis limitation is binding only if the fair market value of the item exceeds three times the item's basis. Thus, a measure of fair market value always is necessary.

[636] Such taxpayers must remove the amount of the contribution deduction for the contributed equipment inventory from opening inventory, and do not treat the removal as a part of cost of goods sold. IRS Publication 526, *Charitable Contributions*, pp. 7-8.

J. Extend Treatment of Alternative Minimum Tax Net Operating Loss Deductions

Present Law

Under present law, generally a taxpayer may carryback a net operation loss ("NOL") two years and may carryover a NOL twenty years, and is allowed to deduct the NOL in the carryback or carryover year. In computing the alternative minimum tax, a NOL deduction generally cannot reduce a taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI (determined without regard to the NOL deduction).

The Job Creation and Worker Assistance Act of 2002 allows an NOL deduction attributable to NOL carrybacks arising in taxable years beginning in 2001 and 2002, as well as NOL carryovers to these taxable years, to offset 100 percent of the taxpayer's AMTI.

Description of Proposal

The proposal allows NOL carrybacks arising in taxable years beginning in 2003, 2004, and 2005, as well as carryovers to these taxable years, to offset 100 percent of the taxpayer's AMTI.

Effective date.–The proposal applies to NOL carryovers to taxable years beginning in 2003, 2004, and 2005, and NOL carrybacks from these taxable years.

Analysis

Policy issues

Generally, the net operating loss deduction allows taxpayers to average a profitable year with a loss year. Under the regular tax, losses are allowed to offset taxable income entirely. The 90-percent limitation on the use of NOL deductions on computing the alternative minimum tax prevents losses on one year from offsetting completely income arising in another taxable year. Thus, a minimum tax may be imposed notwithstanding that the taxpayer had no net income taking into account all items of income and deductions from both years.

Complexity issues

Under the proposal, the number of business taxpayers subject to the alternative minimum tax will be reduced because NOL deductions can reduce the alternative minimum taxable income to zero.

Prior Action

An identical proposal was included in the President's fiscal year 2004 budget proposal.

K. Permanently Extend IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.[637] Public Law 108-89[638] extended the statutory authorization for these user fees through December 31, 2004, and moved the statutory authorization for these fees into the Code.[639]

Description of Proposal

The proposal permanently extends the statutory authorization for these user fees.

Effective date.–The proposal is effective for requests made after the date of enactment.

Analysis

In general, IRS user fees are designed to affect complex requests that relate to specific facts of particular taxpayers, rather that widespread issues of general applicability.

Prior Action

A substantially similar proposal was included in the President's fiscal year 2004 budget proposal.[640] A substantially similar proposal was contained in the "Tax Administration Good Government Act of 2004," as passed by the Senate Committee on Finance on February 2, 2004.

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[637] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. L. No. 100-203, December 22, 1987). Public Law 104-117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)) extended the statutory authorization for these user fees through September 30, 2003.

[638] 117 Stat. 1131; H.R. 3146, signed by the President on October 1, 2003.

[639] Pub. L. No. 108-89 also moved into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16, June 7, 2001).

[640] That proposal extended the statutory authorization for these user fees through September 30, 2005.

L. Extend Provisions Permitting Disclosure of Return Information Relating to Terrorism

Present Law

In general

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied. One of those exceptions is for the disclosure of return and return information regarding terrorist activity.

Among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term "terrorist incident, threat, or activity" is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms are defined in the USA PATRIOT Act.[641]

In general, returns and taxpayer return information must be obtained pursuant to an *ex parte* court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. No disclosures may be made under this provision after December 31, 2003.

Disclosure of returns and return information - by *ex parte* court order

Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies

The Code permits, pursuant to an *ex parte* court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the *ex parte* court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she

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[641] 18 U.S.C. 2331.

determines that: (1) there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and (2) the return or return information is sought exclusively for the use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

<u>Special rule for *ex parte* court ordered disclosure initiated by the IRS</u>

If the Secretary of Treasury possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary of the Treasury (or his delegate), may on his own initiative, authorize an application for an *ex parte* court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary of the Treasury in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS *ex parte* court order.

<u>Disclosure of return information other than by ex parte court order</u>

<u>Disclosure by the IRS without a request</u>

The Code permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

<u>Disclosure upon written request of a Federal law enforcement agency</u>

The Code permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats,

or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Code permits the redisclosure by a Federal law enforcement agency to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information)[642] to officers and employees of the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester under the Act.

Description of Proposal

The proposal extends the disclosure authority relating to terrorist activities. Under the proposal, no disclosures can be made after December 31, 2004.

Effective date.–The proposal is effective for disclosures on or after the date of enactment.

Analysis

The proposal adds complexity to the Code in that its temporary nature introduces a degree of uncertainty on the extent of the disclosure of return information relating to terrorist activities, i.e., whether the provision will be the subject of further extensions.

The additional extension provides additional time to evaluate the effectiveness of the provision and whether any modifications need to be implemented to enhance the provision. On the other hand, some might argue that since the provision has been in place for several years, a

[642] A taxpayer's identity is treated as not having been supplied by the taxpayer or his representative.

permanent decision could be made as to its effectiveness, providing certainty on the extent of the disclosure of return information relating to terrorist activities.

Prior Action

An identical proposal was included in the President's fiscal year 2004 budget proposals.

M. Extend the Authority to Issue Liberty Zone Bonds

Present Law

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

In most cases, the aggregate volume of tax-exempt private activity bonds that may be issued in a State is restricted by annual volume limits. For calendar year 2004, these annual volume limits are equal to the greater of $80 per resident of the State or $234 million.

Tax-exempt private activity bonds

Interest on private activity bonds is tax-exempt only for qualified bonds. Qualified bonds include: (1) exempt facility bonds; (2) qualified mortgage bonds; (3) qualified veteran mortgage bonds; (4) qualified small-issue bonds; (5) qualified student loan bonds; (6) qualified redevelopment bonds; and (7) qualified 501(c)(3) bonds. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Tax-exempt financing is also allowed for qualified New York Liberty Bonds issued during calendar years before January 1, 2005. An aggregate limit of $8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of nonresidential real property[643] and residential rental real property[644] in a newly designated "Liberty Zone" (the

[643] No more than $800 million of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The term nonresidential real property includes structural components of such property if the taxpayer treats such components as part of the real property structure for all Federal income tax purposes (e.g., cost recovery). The $800 million limit is divided equally between the Mayor and the Governor.

[644] No more than $1.6 billion of the authorized bond amount may be used to finance residential rental property. The $1.6 billion limit is divided equally between the Mayor and the Governor.

"Zone") of New York City is allowed.[645] Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements,[646] and public utility property (e.g., gas, water, electric and telecommunication lines). All business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan are considered to be located within the Zone. Issuance of these bonds authorized is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to $4 billion of the bonds authorized under the bill.

If the Mayor or the Governor determines that it is not feasible to use all of the authorized bonds that he is authorized to designate for property located in the Zone, up to $2 billion of bonds may designated by each to be used for the acquisition, construction, and rehabilitation of nonresidential real property (including fixed tenant improvements) located outside the Zone and within New York City.[647] Bond-financed property located outside the Zone must meet the additional requirement that the project have at least 100,000 square feet of usable office or other commercial space in a single building or multiple adjacent buildings.

Subject to the following exceptions and modifications, issuance of these tax-exempt bonds is subject to the general rules applicable to issuance of exempt-facility private activity bonds:

(1) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);

(2) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost of acquiring the building being devoted to rehabilitation (sec. 147(d));

(3) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of the bonds (sec. 148(f)(4)(C));

(4) The tenant targeting rules applicable to exempt-facility bonds for residential rental property (and the corresponding change in use penalties for violations of those

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[645] Current refundings of outstanding New York Liberty Bonds bonds do not count against the $8 billion volume limit to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the bonds being refunded. In addition, qualified New York Liberty Bonds may be issued after December 31, 2004 to refund (other than advance refund) qualified New York Liberty Bonds originally issued before January 1, 2005, to the extent the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. The bonds may not be advance refunded.

[646] Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds.

[647] Public utility property and residential property located outside the Zone cannot be financed with the bonds.

rules) do not apply to such property financed with the bonds (secs. 142(d) and 150(b)(2));

(5) Repayments of bond-financed loans may not be used to make additional loans, but rather must be used to retire outstanding bonds (with the first such retirement occurring 10 years after issuance of the bonds);[648] and

(6) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)).

Description of Proposal

The proposal extends authority to issue New York Liberty Bonds though December 31, 2009.

Effective Date

The provision is effective for bonds issued after the date of enactment and before January 1, 2010.

Analysis

Proponents of the proposal argue that the extraordinary circumstances require an extension of this authority. They propose that additional time is necessary to utilize these bonds and complete the recovery of New York City from the terrorist attacks of September 11, 2001. Opponents may argue that New York City has adequate bonding authority and that any additional extension of this authority is unnecessary.

Prior Action

No prior action.

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[648] It is intended that redemptions will occur at least semi-annually beginning at the end of 10 years after the bonds are issued; however amounts less than $250,000 are not required to be used to redeem bonds at such intervals.

N. Extend Excise Tax on Coal at Current Rates

Present Law

A $1.10 per ton excise tax is imposed on coal sold by the producer from underground mines in the United States. The rate is 55 cents per ton on coal sold by the producer from surface mining operations. The tax cannot exceed 4.4 percent of the coal producer's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Disability Trust Fund to finance benefits under the Federal Black Lung Benefits Act. Currently, the Black Lung Disability Trust Fund is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates are scheduled to decline to 50 cents per ton for underground-mined coal and 25 cents per ton for surface-mined coal (and the cap is scheduled to decline to two percent of the selling price) for sales after January 1, 2014, or after any earlier January 1 on which there is no balance of repayable advances from the Black Lung Disability Trust Fund to the General Fund and no unpaid interest on such advances.

Description of Proposal

The proposal retains the excise tax on coal at the current rates until the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the General Fund. After repayment of the Trust Fund's debt the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines apply and the tax per ton of coal is capped at 2 percent of the amount for which it is sold by the producer.

Effective date.–The proposal would be effective for coal sales after December 31, 2003.

Analysis

Trust fund financing of benefits was established in 1977 to reduce reliance on the Treasury and to recover costs from the mining industry. Claims were much more numerous than expected and it was difficult to find responsible operators, litigate their challenges and collect from them. Therefore, deficits were financed with interest-bearing advances from the General Fund. During each year of the period 1992-2002, the expenses of the program covered by the trust fund (benefits, administration and interest) have exceeded revenues, with an advance from the General Fund making up the difference and accumulating as a debt.[649] Direct costs (benefits and administration), however, have been less than revenues. According to the Congressional Research Service, if it were not for the interest on the accumulated deficit, the trust fund would

[649] Congressional Research Service, RS21239 *The Black Lung Benefits Program* (June 12, 2002) at 6.

be self-supporting: "In effect, the annual advances from the Treasury are being used to pay back interest to the Treasury, while the debt has been growing as if with compound interest."[650]

Miners and survivors qualify for benefits from the Fund only if the miner's mine employment terminated before 1970 or no mine operator is liable for the payment of benefits. Some might argue that since the Federal Government has essentially made a loan to itself with a transfer between funds, the interest component should be forgiven. Because the class of beneficiaries is dwindling and revenues currently cover benefits and administrative costs, coal tax revenues could eventually pay off the bonds if extended at their current rates.

Based on historical trends, it appears that the trust fund will not be able to pay off its debt by December 31, 2013. Therefore, it could be argued that it is appropriate to continue the tax on coal at the increased rates beyond that expiration date until the debt is repaid, rather than require that the General Fund provide even larger advances to the trust fund. On the other hand, since the tax is not scheduled to be reduced until December 31, 2013, it could be argued that this proposal to further extend the rates is premature.

Prior Action

No prior action.

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[650] Id.

IX. EXPAND PROTECTIONS FOR MEMBERS OF THE ARMED FORCES

Present Law

General time limits for filing tax returns

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities. This suspension of the time period rules also applies to persons deployed outside the United States away from the individual’s permanent duty station while participating in an operation designated by the Secretary of Defense as a contingency operation or that becomes a contingency operation. An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President must also designate the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone, as well as (1) any time of continuous qualified

hospitalization resulting from injury received in the combat zone[651] or (2) time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts:

(1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);

(2) Payment of any income, estate, or gift tax (except employment and withholding taxes);

(3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

(4) Allowance of a credit or refund of any tax;

(5) Filing a claim for credit or refund of any tax;

(6) Bringing suit upon any such claim for credit or refund;

(7) Assessment of any tax;

(8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(9) Collection of the amount of any liability in respect of any tax;

(10) Bringing suit by the United States in respect of any liability in respect of any tax; and

(11) Any other act required or permitted under the internal revenue laws specified by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension. Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

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[651] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

Servicemembers Civil Relief Act

In general, section 510 of the Servicemembers Civil Relief Act[652] provides that if a servicemember's ability to pay Federal or State income tax liability falling due before or during military service is materially affected by military service (whether or not in a combat zone), collection activities with respect to the tax liability is deferred for the period of military service and up to 180 days after the servicemember's termination or release from military service. No interest or penalties accrue on the unpaid income tax liability during the period of deferment. The statute of limitations for the collection of the taxes affected by the deferral is also extended. The deferral does not apply to certain Social Security taxes.

Description of Proposal

The proposal makes the provisions of section 7508 that are currently available to members of the Armed Forces in combat zones or contingency operations applicable to all Armed Forces reservists and National Guardsmen called to active duty. Active duty for persons in the National Guard is defined as being called to active duty by the President or the Secretary of Defense for a period of more than 30 consecutive days under section 502(f) of Title 32, United States Code. Accordingly, calls to active duty by a Governor are ineligible for this expanded provision. Parallel rules apply to Armed Forces reservists. In addition, training duty is not considered to be active duty for this purpose.

The proposal extends Section 510 of the Servicemembers Civil Relief Act to suspend the assessment and collection of any state income tax liability for all servicemembers (including Armed Forces reservists and National Guardsmen) serving in a designated combat zone and for all other Armed Forces reservists and National Guardsmen called to active duty.

Effective date.–The proposal would be effective upon enactment.

Analysis

The proposal increases administrative complexity for the Internal Revenue Service. Particularly in cases where the servicemember's ability to pay is not materially affected, it is unclear whether this administrative complexity is warranted.

A separate issue is whether it is appropriate to extend these benefits to all reservists on active duty who in some cases may be stationed alongside regular army members who would not enjoy these benefits.

Prior Action

No prior action.

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[652] Pub. L. No. 108-189, December 19, 2003.

X. RESPOND TO FOREIGN SALES CORPORATION / EXTRATERRITORIAL INCOME DECISIONS

Present Law

Like many other countries, the United States has long provided export-related benefits under its tax law. In the United States, for most of the last two decades, these benefits were provided under the foreign sales corporation ("FSC") regime. In 2000, the European Union ("EU") succeeded in having the FSC regime declared a prohibited export subsidy by the World Trade Organization ("WTO"). Later that year, in response to this WTO ruling, the United States repealed the FSC rules and enacted the extraterritorial income ("ETI") regime.

Under the ETI regime, an exclusion from gross income applies with respect to "extraterritorial income," which is a taxpayer's gross income attributable to "foreign trading gross receipts." This income is eligible for the exclusion to the extent that it is "qualifying foreign trade income." Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction;[653] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[654]

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside the United States that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the

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[653] "Foreign trade income" is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

[654] "Foreign sale and leasing income" is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes. Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

United States. No more than 50 percent of the fair market value of such property can be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

Shortly after enactment of the ETI regime, the EU brought a case against the United States in the WTO. In August of 2001, a WTO panel held that the ETI regime constituted a prohibited export subsidy under the relevant WTO agreements,[655] and a WTO Appellate Body later affirmed the Panel's findings (but modified the Panel's reasoning in part).[656] The EU has received authorization from a WTO arbitration panel to impose up to $4 billion per year in trade sanctions against U.S. exports in connection with the case. In response, the EU Council of Foreign Affairs Ministers adopted a regulation providing for sanctions against U.S. exports to be phased in beginning March 2004 if the United States has not come into compliance with the WTO decision by such date.

Description of Proposal

The President's budget submission proposes the repeal of the ETI regime and proposes that the regime be replaced with tax law changes that enhance the global competitiveness of U.S.-based businesses and increase the competitiveness of American manufacturers and other job creating sectors of the economy. The submission identifies several possible tax law changes that are "deserving of consideration," including: (1) the permanent extension and simplification of the research and experimentation tax credit; (2) the permanent extension of increased expensing for small businesses; (3) the extension through 2005 of the waiver on the use of net operating losses under the alternative minimum tax; (4) the reduction of the corporate income tax rates; (5) the reform of the alternative minimum tax; (6) the reform of the depreciation rules; (7) the simplification of the business tax rules, generally; and (8) the rationalization and simplification of the international tax rules (including reform of the interest allocation rules).

Analysis

The budget submission proposes the repeal of the ETI regime and its replacement with various tax law changes. In describing the possible tax law changes worthy of consideration, Treasury describes several areas of the Code that it believes are in need of reform, rather than

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[655] United States -- Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

[656] United States -- Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002.

proposing a specific set of measures.[657] Consequently, no detailed policy or complexity analysis is appropriate with respect to the submission.

Prior Action

In July 2002, Mr. Thomas, Chairman of the House Committee on Ways and Means, introduced H.R. 5095, the "American Competitiveness and Corporate Accountability Act of 2002." Among other provisions, H.R. 5095 provided for repeal of the ETI regime, accompanied by a number of changes to the U.S. international tax rules.

The President's Fiscal Year 2004 Budget Proposal outlined general principles that should govern the U.S. response to the FSC/ETI decisions of the WTO and proposed that the repeal of the ETI regime should be accompanied by other changes to the U.S. international tax rules.

In April 2003, Representatives Phillip Crane and Charles Rangel, House Ways and Means Trade Subcommittee chairman and the Committee on Ways and Means's ranking member, respectively, introduced H.R. 1769. The bill provided for the repeal of the ETI regime, accompanied by a deduction relating to income attributable to United States production activities.

In July 2003, Mr. Thomas introduced H.R. 2896, the "American Jobs Creation Act of 2003." Among other provisions, H.R. 2896 generally provided for the repeal of the ETI regime, accompanied by a number of business tax law changes and a number of changes to the U.S. international tax rules. In October 2003, the Committee on Ways and Means reported H.R. 2896, as modified, out of committee. As modified, the bill also provided for a reduced corporate income tax rate for domestic production activities.

In September of 2003, Senators Grassley and Baucus, Chairman of the Senate Committee on Finance and the committee's ranking member, respectively, introduced S. 1637, the "Jumpstart our Business Strength Act." Among other provisions, S. 1637 provided for the repeal of the ETI regime, accompanied by several business tax law changes, several U.S. international tax law changes, and a deduction relating to income attributable to United States production activities. In October 2003, the Senate Committee on Finance reported H.R. 2896, as modified, out of committee.

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[657] The President's budget also contains proposals for the permanent extension of increased expensing for small businesses (sec. I. B), the extension of the research and experimentation tax credit (sec. VIII. B.), and the extension of the waiver on the use of net operating losses under the alternative minimum tax (sec. VIII. J).

XI. OTHER PROVISIONS MODIFYING THE INTERNAL REVENUE CODE

A. Extension of the Rate of Rum Excise Tax Cover Over to Puerto Rico and Virgin Islands

Present Law

A $13.50 per proof gallon[658] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[659] The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[660]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[661] The amount of the cover over is limited under Code section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2003).[662]

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[663] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[664] All of the amounts covered over are subject to the limitation.

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[658] A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

[659] Sec. 5001(a)(1).

[660] Secs. 5062(b), 7653(b) and (c).

[661] Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

[662] The amount covered over is limited to the amount of excise tax imposed under section 5001(a)(1), if lower than the limits stated above. Sec. 7652(f)(2).

[663] Sec. 7652(e)(2).

[664] Secs. 7652(a)(3), (b)(3), and (e)(1).

Description of Proposal

The proposal extends the $13.25-per-proof-gallon cover over rate for two additional years, through December 31, 2005.

Effective date.–The proposal is effective for articles brought into the United States after December 31, 2003.

Analysis

The fiscal needs of Puerto Rico and the Virgin Islands were the impetus to extend the increased cover over rate to bolster the Treasuries in those possessions. Rather than rely on rum consumption in the United States, increased revenue could be achieved by intergovernmental support through a direct appropriation. The advantage of a direct appropriation is that it provides for annual oversight. Some might argue that a cover over is akin to an entitlement in terms of the annual budget process and making it permanent ensures a steady flow of revenue. Although the cover over may provide a more stable revenue stream, it may be more difficult to administer than a direct appropriation.

Prior Action

The President's fiscal year 2001 budget proposal included a proposal that would have repealed the $20 million limit on amounts attributable to the increased cover over rate that could be paid to Puerto Rico and the Virgin Islands in fiscal year 2001. An identical proposal was also included in the President's fiscal year 2004 budget proposals.

B. Merge Treasury Inspector General for Tax Administration and Treasury Inspector General into New Inspector General for Treasury

Present Law

In general

The IRS Restructuring and Reform Act of 1998 ("the Act") established a new, independent, Treasury Inspector General for Tax Administration ("Treasury IG for Tax Administration") within the Department of Treasury. The IRS Office of the Chief Inspector[665] was eliminated, and all of its powers and responsibilities were transferred to the Treasury IG for

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[665] The IRS Office of the Chief Inspector (also known as the "Inspection Service") was established on October 1, 1951, in response to publicity revealing widespread corruption in the IRS. At the time of its creation, President Harry S. Truman stated, "A strong, vigorous inspection service will be established and will be made completely independent of the rest of the Internal Revenue Service." In 1952, the Office of the Assistant Commissioner (Inspection) was established. The office was redesignated as the Office of the Chief Inspector on March 25, 1990. The Chief Inspector was appointed by the Commissioner.

The Office of the Chief Inspector generally was responsible for carrying out internal audits and investigations that: (1) promote the economic, efficient, and effective administration of the nation's tax laws; (2) detect and deter fraud and abuse in IRS programs and operations; and (3) protect the IRS against external attempts to corrupt or threaten its employees. The Chief Inspector reported directly to the Commissioner and Deputy Commissioner of the IRS.

The IRS Inspection Service was divided into three functions: Internal Security, Internal Audit, and Integrity Investigations and Activities. Internal Security's responsibilities include criminal investigations (employee conduct, bribery, assault and threat and investigations of non-IRS employees for acts such as impersonation, theft, enrolled agent misconduct, disclosure, and anti-domestic terrorism) investigative support activities (including forensic lab, computer investigative support, and maintenance of law enforcement equipment), protection, and background investigations.

Internal Audit was responsible for providing IRS management with independent reviews and appraisals of all IRS activities and operations. In addition, Internal Audit made recommendations to improve the efficiency and effectiveness of programs and to assist IRS officials in carrying out their program and operational responsibilities. In this regard, Internal Audit generally conducted performance reviews (program audits, system development audits, internal control audits) and financial reviews (financial statement audits and financial related reviews).

Integrity Investigations and Activities were joint internal audit and internal security operations undertaken as a proactive effort to detect and deter fraud and abuse within the IRS.

The Office of the Chief Inspector had full access to taxpayer returns and return information.

Tax Administration. The role of the existing Treasury IG was redefined to exclude responsibility for the IRS. The Treasury IG for Tax Administration is under the supervision of the Secretary of Treasury, with certain additional reporting to the IRS Oversight Board (the "Board") and the Congress.

The Treasury Office of Inspector General ("Treasury IG") was established in 1988 and is charged with conducting independent audits, investigations and review to help the Department of Treasury accomplish its mission, improve its programs and operations, promote economy, efficiency and effectiveness, and prevent and detect fraud and abuse.

Treasury IG for Tax Administration

The Treasury IG for Tax Administration is selected by the President, with the advice and consent of the Senate. The Treasury IG for Tax Administration can be removed from office by the President. The President must communicate the reasons for such removal to both Houses of Congress.

The Treasury IG for Tax Administration must be selected without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations. The Treasury IG for Tax Administration may not be employed by the IRS within the two years preceding and the five years following his or her appointment.

Duties and responsibilities of Treasury IG for Tax Administration

The Treasury IG for Tax Administration is charged with conducting audits, investigations, and evaluations of IRS programs and operations (including the Board) to promote the economic, efficient and effective administration of the nation's tax laws and to detect and deter fraud and abuse in IRS programs and operations. In this regard, the Treasury IG for Tax Administration specifically is directed to evaluate the adequacy and security of IRS technology on an ongoing basis. The Treasury IG for Tax Administration is charged with investigating allegations of criminal misconduct as well as administrative misconduct. The Act provides, however, that the responsibility for (1) protecting IRS employees and (2) investigating the backgrounds of prospective IRS employees shall not be transferred to the Treasury IG for Tax Administration, but shall remain with the IRS.

In addition, the Act directs the Treasury IG for Tax Administration to implement a program periodically to audit at least one percent of all determinations (identified through a random selection process) where the IRS has asserted either section 6103 (directly or in connection with the Freedom of Information Act or the Privacy Act) or law enforcement considerations (i.e., executive privilege) as a rationale for refusing to disclose requested information. The Treasury IG for Tax Administration is directed to report any findings of improper assertion of section 6103 or law enforcement considerations to the Board.

Authority of Treasury IG for Tax Administration

The Treasury IG for Tax Administration reports to and is under the general supervision of the Secretary of Treasury. Under the Act, the Secretary cannot prevent or prohibit the Treasury

IG for Tax Administration from initiating, carrying out, or completing any audit or investigation or from issuing any subpoena during the course of any audit or investigation.

Under the Act, the Treasury IG for Tax Administration must provide to the Board all reports regarding IRS matters on a timely basis and conduct audits or investigations requested by the Board. The Treasury IG for Tax Administration also must, in a timely manner, conduct such audits or investigations and provide such reports as may be requested by the Commissioner. In addition, the Act provides that the Commissioner or the Board may request the Treasury IG for Tax Administration to conduct an audit or investigation relating to the IRS. If the Treasury IG for Tax Administration determines not to conduct an audit or investigation requested by the Commissioner or the Board, the Treasury IG for Tax Administration shall timely provide the requesting party with a written explanation of its determination. In this regard, it is intended that the Treasury IG for Tax Administration shall make all reasonable efforts to be responsive to the requests of the Commissioner and the Board.

Resources

To ensure that the Treasury IG for Tax Administration had sufficient resources to carry out his or her duties and responsibilities under the Act, approximately 900 FTEs from the IRS Office of the Chief Inspector were transferred to the Treasury IG for Tax Administration. Such FTEs included all of the FTEs performing investigative functions in the Office of the Chief Inspector Internal Security and Integrity Investigations and Activities.

The Commissioner retained approximately 300 FTEs from the IRS Office of the Chief Inspector to staff an audit function (including support staff) for internal IRS management purposes. Like other IRS functions, however, this audit function is subject to oversight and review by the Treasury IG for Tax Administration.

Access to taxpayer returns and return information

Taxpayer returns and return information are available for inspection by the Treasury IG for Tax Administration pursuant to section 6103(h)(1). Thus, the Treasury IG for Tax Administration has the same access to taxpayer returns and return information as does the Chief Inspector under prior law.

Treasury IG

The Treasury IG for Tax Administration operates independently of the Treasury IG. The Secretary of Treasury was directed to establish procedures pursuant to which the Treasury IG for Tax Administration and the Treasury IG shall coordinate audits and investigations in cases involving overlapping jurisdiction. The Treasury IG generally does not have access to taxpayer returns and return information under section 6103 (unless carrying out responsibilities related to tax administration).

The Treasury IG has responsibility for providing an opinion on the Department of Treasury's consolidated financial statement as required under the Chief Financial Officer Act. The Treasury IG for Tax Administration is responsible for rendering an opinion on the IRS

custodial and administrative accounts (to the extent the Government Accounting Office does not exercise its option to preempt under the CFO Act).

Description of Proposal

The President's budget proposes the merger of the Treasury Inspector General and the Treasury Inspector General for Tax Administration into a new Inspector General office, to be called the Inspector General for Treasury.[666]

Effective date.–No effective date is specified.

Analysis

Proponents of the proposal believe that the consolidation of these two organizations will "maximize efficiencies and effectiveness."[667] Others may question why a structure that was examined intensively and enacted in 1998 needs to be readjusted so soon thereafter. Some may also be concerned that this consolidation will result in a diminution of focus and attention on the IRS, since there will no longer be an inspector general with that exclusive responsibility. In addition, some might argue that the merging of tax and non-tax administration investigative functions increases the risk of unauthorized disclosure of returns and return information for nontax purposes because Treasury IG personnel may not be assigned exclusively to tax administration investigations; accordingly, the possibility exists of inadvertent disclosure because of a mixed tax and non-tax workload.

Prior Action

An identical proposal was included in the President's fiscal year 2004 budget proposal.

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[666] *See* Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005: Appendix* (H. Doc. 108-146, Vol. II), p. 830.

[667] *See* Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005: Appendix* (H. Doc. 108-146, Vol. II), p. 830.