[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSAL

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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 and other provisions modifying the Internal Revenue Code (the "Code") that are contained in the President's fiscal year 2004 budget proposal, as submitted to the Congress on February 3, 2003.[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), a reference to relevant prior budget proposals or recent legislative action, and an analysis of policy issues related to the proposal.

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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 2004 Budget Proposal* (JCS-7-03), March 2003.

[2] *See* Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004: Analytical Perspectives* (H. Doc. 108-3, Vol. III), pp. 66-81.

[3] *See* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003.

I. ECONOMIC GROWTH PACKAGE

A. Accelerate Reductions in Individual Income Tax Rates

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2003, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

Table 1.–Individual Regular Income Tax Rates for 2003

If taxable income is:	**But not over:**	**Then regular income tax equals**:
		Single individuals
$0	$6,000	10% of taxable income
$6,000	$28,400	$600, plus 15% of the amount over $6,000
$28,400	$68,800	$3,960.00, plus 27% of the amount over $28,400
$68,800	$143,500	$14,868.00, plus 30% of the amount over $68,800
$143,500	$311,950	$37,278.00, plus 35% of the amount over $143,500
Over $311,950		$96,235.50, plus 38.6% of the amount over $311,950

Heads of households

$0................................$10,000	10% of taxable income
$10,000........................$38,050	$1,000, plus 15% of the amount over $10,000
$38,050........................$98,250	$5,207.50, plus 27% of the amount over $38,050
$98,250........................$159,100	$21,461.50, plus 30% of the amount over $98,250
$159,100......................$311,950	$39,716.50, plus 35% of the amount over $159,100
Over $311,950..............	$93,214, plus 38.6% of the amount over $311,950

Married individuals filing joint returns

$0................................$12,000	10% of taxable income
$12,000........................$47,450	$1,200, plus 15% of the amount over $12,000
$47,450........................$114,650	$6,517.50, plus 27% of the amount over $47,450
$114,650......................$174,700	$24,661.50, plus 30% of the amount over $114,650
$174,700......................$311,950	$42,676.50, plus 35% of the amount over $174,700
Over $311,950..............	$90,714, plus 38.6% of the amount over $311,950

<u>Ten percent regular income tax rate</u>

Under present law, the ten-percent rate applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. Effective beginning in 2008, the $6,000 amount will increase to $7,000 and the $12,000 amount will increase to $14,000.

The taxable income levels for the ten-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The bracket for single individuals and married individuals filing separately is one-half for joint returns (after adjustment of that bracket for inflation).

<u>Reduction of other regular income tax rates</u>

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") the regular income tax rates were 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. EGTRRA added the ten-percent regular income tax rate, described above, and retained the 15-percent regular income tax rate. Also, the 15-percent regular income tax bracket was modified to begin at the end of the ten-percent regular income tax bracket. EGTRRA also made other changes to the 15-percent regular income tax bracket.[4]

[4] *See* the discussion of the provision regarding marriage penalty relief in the 15-percent regular income tax bracket, below.

Also, under EGTRRA, the 28 percent, 31 percent, 36 percent, and 39.6 percent rates are phased down over six years to 25 percent, 28 percent, 33 percent, and 35 percent, effective after June 30, 2001. Accordingly, for taxable years beginning during 2001, the rate reduction comes in the form of a blended tax rate. The taxable income levels for the rates above the 15-percent rate in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 2, below, shows the schedule of regular income tax rate reductions.

Table 2.–Scheduled Regular Income Tax Rate Reductions

Calendar Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001[1]-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35.0%

1 Effective July 1, 2001.

Alternative minimum tax

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $24,500 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Description of Proposal

Ten percent regular income tax rate

The proposal accelerates the scheduled increase in the taxable income levels for the ten-percent rate bracket from 2008 to 2003. Specifically, the proposal increases the taxable income level for the ten-percent regular income tax rate brackets for single individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000, respectively. The taxable income levels for the ten-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

Reduction of other regular income tax rates

The proposal accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, the regular income tax rates in excess of 15 percent under the proposal are 25 percent, 28 percent, 33 percent, and 35 percent for 2003 and thereafter.

Alternative minimum tax exemption amounts

The proposal increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $57,000, and for unmarried taxpayers to $39,750 for taxable years beginning in 2003, 2004, and 2005.

Effective date

The proposal is effective for taxable years beginning after December 31, 2002.

Analysis

See the general discussion following the description of the proposal to accelerate the increase in the child tax credit, below.

Prior Action

No prior action.

B. Accelerate Marriage Penalty Relief

1. Standard deduction marriage penalty relief

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable), [5] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2003, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns (Alternatively, the basic standard deduction for married couples filing a joint return is 167 percent of the basic standard deduction for single filers). Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same.

An increase in the standard deduction is scheduled to be phased-in over five years beginning in 2005 and will be fully phased-in for 2009 and thereafter. Table 3, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

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[5] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

Table 3.–Scheduled Phase-In of Increase of the Basic Standard Deduction for Married Couples Filing Joint Returns

Calendar Year	Standard Deduction for Joint Returns as Percentage of Standard Deduction for Single Returns
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

Description of Proposal

The proposal accelerates the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002.

Analysis

See the general discussion following the description of the proposal to accelerate the increase in the child tax credit, below.

Prior Action

No prior action.

2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[6] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

15-percent regular income tax rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return is twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 4, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 4.–Scheduled Increase in Size of the 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals
2005	180%
2006	187%
2007	193%
2008 and thereafter	200%

Description of Proposal

The proposal accelerates the increase of the size of the 15-percent regular income tax rate bracket for joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns effective for 2003.

[6] The rate bracket breakpoint for the 38.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002.

Analysis

See the general discussion following the description of the proposal to accelerate the increase in the child tax credit, below.

Prior Action

No prior action.

C. Accelerate the Increase in the Child Tax Credit

Present Law

In general

For 2003, an individual may claim a $600 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter (or descendent of either), or eligible foster child.

The child tax credit is scheduled to increase to $1,000, phased-in over several years.

Table 5, below, shows the scheduled increases of the child tax credit.

Table 5.–Scheduled Increase of the Child Tax Credit

Calendar Year	Credit Amount Per Child
2003-2004	$600
2005-2008	$700
2009	$800
2010 and later[7]	$1,000

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified 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. Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)). The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $95,000.

The child tax credit is not adjusted annually for inflation.

Refundability

The child credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,500 for calendar years 2003.[8] The percentage is increased to 15 percent for

[7] The credit reverts to $500 in taxable years beginning after December 31, 2010 under the sunset provision of EGTRRA.

calendar years 2005 and thereafter. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the present and prior-law rule), if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,500 for 2003. The refundable portion of the child credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Alternative minimum tax liability

The child credit is allowed against the individual's regular income tax and alternative minimum tax.

Description of Proposal

The amount of the child credit is increased to $1,000 for 2003 and thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be made in a similar manner to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket. The increase in refundability to 15 percent of the taxpayer's earned income scheduled for calendar years 2005 and thereafter is not accelerated by the proposal.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002.

Analysis

See below.

Prior Action

No prior action.

Analysis for Acceleration Proposals

The acceleration of (1) the reduction in individual income tax rates, (2) the expansion of the ten-percent bracket, (3) the expansion of the fifteen-percent rate bracket for married taxpayers filing jointly, (4) the increase in the standard deduction for married taxpayers filing jointly, and (5) the increase in the child credit represent the current implementation of policies that are slated, under present law, to go into effect at a certain point in the future. In some respects, therefore, it can be argued that the acceleration of these policies raises only issues regarding the budgetary effects of implementing these policies now rather than under the present law timetable--because the underlying policy choices (e.g., reducing the marriage penalty) have already been made. However, it also can be argued that the current Congress and President, or a

[8] The $10,500 amount is indexed for inflation.

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 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, if any. Greater progressivity produces a more equal after-tax distribution of income in society, which some 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 ten percent bracket and the reduction in rates, as provided for in EGTRRA, did little to alter 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.

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.[9] 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.[10] 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. 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.

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

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[9] Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current 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 tax rates, 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.

[10] 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.

not have more ability to pay income tax than the two-earner married couple with the same income.[11]

Prior to the effective date of the enacted increases in the standard deduction for joint filers, the sum of the 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.[12] Furthermore, because of the way the bracket breakpoints are structured, 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 standard deduction, the 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 expanding the standard deduction for married couples and increasing the 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.[13] It does not necessarily improve the marriage-neutrality of the tax system, as the proposal enhances marriage bonuses.

Marriage penalty efficiency issues

Most analysts view the marriage penalty primarily 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. There is no statistical evidence that the marriage penalty has altered taxpayers' decisions to marry. Even if the marriage decision were distorted, it would be difficult to measure the cost to society of delayed or accelerated marriages or alternative family structures.[14]

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

[11] If the two-earner couple had child care expenses some would argue 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.

[12] 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.

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

[14] Marriage bonuses may similarly distort taxpayer behavior.

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 28-percent tax bracket marries a man who currently is unemployed. If they had remained single and the man became employed, the first $7,450 of his earnings would be tax-free.[15] However, because he marries a woman in the 28-percent income tax bracket, if he becomes employed he would have a tax liability of 28 cents on his first dollar of earnings, leaving a net of 72 cents for his labor.[16] 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.[17]

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. 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

[15] As a single taxpayer, the man could claim the standard deduction of $4,550 and one personal exemption of $2,900 for 2001, effectively exempting the first $7,450 of his earnings. This example ignores payroll taxes.

[16] This example assumes that as a result of the marriage the combined income is still high enough to place the couple in the 28 percent bracket with respect to the rate schedule for married taxpayers filing jointly. It is possible that if the woman were just into the 28-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 28 percent to 15 percent.

[17] *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*, pp. 10-12, also reviews this literature.

individuals from entering the work force or it may discourage those already in the labor force from working additional hours.[18]

By increasing the size of the fifteen-percent bracket for married taxpayers filing jointly to twice that of single taxpayers, single taxpayers in the fifteen percent bracket or below will generally 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. Some criticize the present-law child credit as too small because the current maximum amount of the credit does not adequately reflect the cost of raising a child. Proponents of an expansion of the size of the child credit argue that $600 is inadequate, even if taken together with the personal exemption available for each qualifying child. They argue that the credit should be increased to better reflect 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.

The President's proposal requires that the 2003 increase in the child credit be paid in advance, beginning in July 2003, based on information in the taxpayer's 2002 tax return, rather than have the increase in the credit claimed when the taxpayer files his or her 2003 tax return. Proponents argue that advancing the payment will provide "economic stimulus" by providing the tax reduction earlier. Others doubt whether short-term stimulus provided beginning in July is preferable to stimulus beginning when taxpayers begin to file their 2003 returns next year. Furthermore, opponents of the advance payment idea may argue that taxpayers can take action themselves to receive the expected tax reductions earlier by adjusting withholding or estimated tax payments.

The advanced payment raises certain administrative issues. In general, based on the experiences with the advanced payment of the ten-percent rate bracket credit of EGTRRA, Treasury and the IRS ably handled the processing of the checks when it was done outside of the filing season, as the President's proposal calls for. As with EGTRRA, taxpayers filing for extensions will in many cases not have completed their 2002 returns. Finally, by using information from a prior year's tax return, some taxpayers will be mailed checks that they would not have been entitled to during the actual filing season for 2003. This would happen, for example, in the case of a taxpayer eligible for the child credit in 2002 whose income rose sufficiently in 2003 to make him ineligible for the credit.

[18] 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.

Mailing checks in advance of the 2003 filing season, rather than waiting for the increase in the credit to be claimed on taxpayer returns when filed, results in increased costs for processing, paper supplies, and postage. Treasury and IRS personnel may also be diverted from performing other important functions. Additionally, forms will have to be revised and additional instructions issued to reconcile advanced payment of a portion of the credit with the credit claimed on the 2003 return when filed. If these monetary and other costs outweigh the advantages of the earlier payment of the credit, it would be advisable to handle the increase in the child credit in the regular filing season.

D. Eliminate the Double Taxation of Corporate Earnings

Present Law

Under present law, a corporation pays a tax on its taxable income, generally at the rate of 35 percent.[19] To the extent that a corporation distributes its after-tax earnings and profits as a dividend to an individual shareholder, the recipient includes the amount of the dividend in gross income and pays tax at the shareholder's individual tax rate. The after-tax earnings and profits of a corporation consist of earnings that have been taxed to the corporation and earnings that have not been subject to tax due to exclusions, accelerated deductions and credits. A tax is imposed at capital gain rates on the gain of a shareholder at the time the shareholder sells his or her stock.

Under present law, corporations receiving dividends from domestic corporations generally are allowed a deduction of 70 percent or more of the amount of the dividends received. Certain anti-abuse rules prevent corporations from receiving low-taxed dividends and creating a capital loss.[20] The dividends-received deduction on certain debt-financed portfolio stock is reduced.[21]

Description of Proposal[22]

In general

Under the proposal, the excludable portion of any dividend received by a shareholder is not included in gross income. The excludable portion of any dividend is the portion of the dividend which bears the same ratio to the dividend as the amount of the corporation's excludable dividend amount ("EDA") for a calendar year bears to all dividends paid by the corporation during the calendar year. The EDA, as discussed below, generally measures the corporation's fully taxed income reduced by taxes paid. In addition, shareholders may be allowed to increase the basis in their corporate stock to the extent the EDA exceeds the dividends paid by the corporation during the calendar year. These rules apply to both individual and corporate shareholders.[23]

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[19] Lower rates apply to the first $75,000 of taxable income. The benefits of the lower rates are phased-out.

[20] Secs. 246(c) and 1059.

[21] Sec. 246A.

[22] The description reflects the proposal as set forth in H.R. 2 (introduced by Chairman Thomas) and S. 2 (introduced by Senators Nickles and Miller) on February 27, 2003.

[23] Certain taxable dividends received by a parent corporation from a subsidiary and taxable dividends received by a small business investment company will continue to receive a 100-percent dividends-received deduction to the extent not excludable.

Excludable dividend amount

A corporation calculates an EDA that measures the amount of the corporation's income that was fully taxed reduced by taxes paid. The EDA, for any calendar year, includes an amount the numerator of which is the amount of Federal income tax[24] in excess of all nonrefundable credits (other than the foreign tax credit and the minimum tax credit attributable to any minimum tax imposed in a taxable year ending before April 1, 2001) shown on a corporation's income tax return filed during the preceding calendar year ("applicable income tax") and the denominator of which is the highest corporate tax rate (35 percent under present law).[25] An assessment of tax not shown on a return is treated as if it were an amount of tax shown on a return for the calendar year in which the tax is assessed. If a tax is paid after the close of the year that it is shown on a return or otherwise assessed, the tax is taken into account in the year paid. The EDA is decreased by the amount of the Federal income tax taken into account in computing the increase in the EDA. No tax imposed for a taxable year ending before April 1, 2001, is treated as an applicable income tax.[26]

The EDA also includes the amount of dividends received from another corporation in the preceding calendar year that are excluded under this provision or amounts added to the basis of stock in the other corporation in the preceding calendar year (as described below).

To the extent that the EDA for a calendar year exceeds the maximum amount of dividends that can be paid by the corporation in the calendar year (determined by reference to the corporation's earnings and profits), the excess is added to the EDA for the succeeding year. No other carryover of an amount in the EDA is allowed except to the extent provided by regulations.

Retained earnings basis adjustments

If the amount of the EDA for a calendar year exceeds the amount of dividends paid by a corporation during that year, a shareholder is allowed to increase the shareholder's basis in the

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[24] For this purpose, the income tax includes the taxes imposed on a corporation by sections 11 (corporate income tax), 55 (alternative minimum tax), 511 (unrelated business income tax), 801 (life insurance company income tax), 831 (nonlife insurance company income tax), 882 (income tax on foreign corporations connected with U.S. business), 1201 (alternative capital gain tax), and 1291 (without regard to section 1291(c)(1)(B)) (tax on distributions from a passive foreign investment companies) and 1374 (tax on built-in gains of S corporations). It also includes the accumulated earnings tax and the personal holding company tax prior to their repeal by the proposal.

[25] For this purpose, a timely filed return is treated as filed in the calendar year which includes the date that is the 15th day of the 9th month following the close of the corporation's taxable year.

[26] A corporation whose taxable year ends April 30, 2001, and that files a timely income tax return and pays the tax is treated for purposes of computing an EDA as having filed the return on January 15, 2002 (the date that is the 15th day of the 9th month following the close of the taxable year).

corporation's stock by the portion (if any) of the excess allocated by the corporation to the stock. Basis increases are allocated by a corporation in the same manner as if the corporation actually had made dividend distributions, except that no amount may be allocated to stock described in section 1504(a)(4) (whether or not voting stock) that is limited and preferred as to dividends. The Secretary of the Treasury may prescribe regulations regarding allocations where a corporation has multiple classes of stock. Earnings and profits are adjusted in the same manner as if the allocation were a dividend (i.e., the distributing corporation's earnings and profits are reduced and, if the taxpayer receiving a basis adjustment is a corporation, that corporation's earnings and profits are increased). The allocated basis is added to the shares of stock the taxpayer holds and does not affect the holding periods of the shares.

Cumulative retained earnings basis adjustments account

Each corporation allocating basis adjustments is required to maintain a cumulative retained earnings basis adjustment account ("CREBAA"). The amount in the CREBAA is the cumulative amount of basis allocations for prior calendar years reduced by the amount of distributions in prior calendar years that were treated as described below.

To the extent of the amount in the CREBAA, distributions made by a corporation in a calendar year in excess of the amount in the EDA are not treated as dividends. Instead, the distributions reduce the basis of the shareholder's stock (or result in gain to the extent the distributions exceed the shareholder's basis).[27] These distributions reduce the amount in the CREBAA. The portion of any distribution to which this treatment applies is a fraction (not in excess of one) the numerator of which is the amount in the CREBAA account at the beginning of the calendar year and the denominator of which is the amount of all distributions (other than excluded dividends) paid by the corporation during the calendar year. This treatment is provided separately with respect to each class of stock for which a basis allocation was previously made.

For example, corporation X, a calendar year corporation, has a sole shareholder A. For its first taxable year, X has taxable income of $100, and files a return and pays a tax of $35 in its second taxable year. For all other taxable years in this example, X has no income or loss. On January 1 of its third taxable year, X has an EDA of $65 ($35/.35 less $35). X pays no dividends in the third year but allocates $65 of basis to A, and A increases its basis in the X stock by $65. X has a CREBAA of $65 at the beginning of the fourth year. The value of the X stock declines, and A sells the stock to B for $50 at the beginning of the fourth year. A's gain or loss is computed by taking the $65 into account in determining the basis in the X stock. X then distributes $65 to B later in the fourth year. B treats the $65 as a $50 reduction of the basis in the X stock to zero and a $15 capital gain from the sale of the X stock. X will have no balance in its CREBAA at the beginning of the fifth year.

[27] For purposes of this description, these distributions are referred to as distributions from a CREBAA.

Credits and refunds of overpayments of tax

The overpayment of a corporate income tax (including an overpayment resulting by reason of a carryback) is allowed as a credit or refund only to the extent of the applicable income taxes taken into account in computing EDA for the calendar year following the calendar year in which the refund or credit is otherwise allowable plus, to the extent the corporation elects, an amount equal to the amount of tax that would produce the amount equal to the EDA for the calendar year in which the refund or credit is otherwise allowable. Thus, for example, assume a corporation has paid no tax in the current calendar year and has an EDA of $65 for the current calendar year. The refund of any overpayment in the year is limited to $35 (the amount of applicable income tax which results in an EDA of $65).

To the extent a credit or refund is made, for purposes of computing EDA, the tax for the calendar year the refund or credit is made is reduced (but not below zero) by the amount of the credit or refund, and the excess (if any) reduces the amount in the EDA for the current calendar year, using the formula which converts applicable income tax to an EDA. Thus, in the above example, the EDA for the current calendar year is reduced to zero.

Any overpayment not allowed as a credit or refund by reason of this limitation continues to be an overpayment that will be taken into account in succeeding calendar years, subject to this limitation, until a credit or refund is allowed or made. Interest on an overpayment is not allowed during the period the overpayment is not allowed as a credit or refund by reason of this limitation.

This limitation does not apply to the extent any overpayment is attributable to the foreign tax credit.

Foreign taxes and foreign persons

Treatment of foreign taxes

The foreign tax credit allowable to a domestic corporation does not reduce the amount of the applicable income tax of the corporation. Thus, to the extent the foreign tax credit is allowable, foreign taxes of a domestic corporation are treated as taxes paid for purposes of computing the EDA.

Treatment of distributions from foreign corporations

The EDA of a foreign corporation takes into account only the tax on taxable income effectively connected with the conduct of a U.S trade or business. The EDA is reduced by the amount of any branch profits tax imposed. Also, a foreign corporation's EDA is increased by (i) the excludable portion of any dividend received in excess of any U.S. withholding tax, and (ii) by the amount any distribution from a CREBAA in excess of any U.S. withholding tax.

No foreign tax credit is allowed with respect to the excludable portion of any dividend or from a distribution from a CREBAA.

Taxation of foreign shareholders

In the case of foreign shareholders, both individual and corporate, withholding taxes apply to all dividends and distributions from a CREBAA. Dividends are not treated as excludable and basis adjustments are not made with respect to stock held by foreign persons.

Regulated investment companies (RICs) and Real Estate Investment Trusts (REITs)

Except as provided in regulations, a regulated investment company ("RIC") or real estate investment trust ("REIT") does not have an EDA. Instead special rules allow the treatment of distributions received by, or basis adjustments allocated to, a RIC or REIT to pass through to its shareholders and holders of beneficial interests.

A RIC or REIT that receives excludable dividend income is allowed to designate dividends it makes to its shareholders as excludable dividends to the extent of the amount of excludable dividends it receives. In addition, a RIC or REIT may cause its shareholders to increase their bases in RIC or REIT stock to the extent of any basis increases allocated to stock held by the REIC or REIT. To the extent a RIC or REIT receives distributions from a CREBAA that reduce the basis of stock held by the RIC or REIT, distributions from the RIC or REIT may be treated as distributions from a CREBAA.

A RIC or REIT takes into account excludable dividends received, and distributions from a CREBAA that reduce the basis in stock it holds, in determining its distribution requirements. Excludable dividends and distributions from a CREBAA received by a RIC or REIT are taken into account in applying the gross income tests applicable to RICs and REITs.

If a shareholder or holder of a beneficial interest of a RIC or REIT receives an excludable dividend or is allocated a basis adjustment, any loss on the sale of the RIC or REIT stock held six months or less is disallowed to the extent of the amount of the exclusion or adjustment.

Insurance companies

Under the proposal, all excludable dividends received by a life insurance company are subject to proration. Thus, the excluded dividends are allocated on a pro rata basis between the insurance company's general earnings and those amounts required to pay benefits. The basis increase allocated to an insurance company is treated as an excludable dividend received in the year the adjustment is made, and, as such, is subject to proration. All excludable dividends and basis increases attributable to assets held in a separate account funding variable life insurance and annuity contracts are allocated to the separate account. The policyholder's share of excludable dividends and basis adjustments is includable in the company's income. The company's share of excludable dividends and basis adjustments is added to the shareholder's surplus account of a stock life insurance company.

Excludable dividends and retained earnings basis adjustments of a non-life insurance company are treated in the same manner as taxable dividends in computing the reduction of the deduction for losses.

Partnerships and S corporations

Excluded dividends and basis adjustments received by, or allocated to, partnerships and S corporations

Excludable dividends received by a partnership and basis adjustments to stock held by a partnership pass through to the partners. A partner's adjusted basis in his or her partnership interest is adjusted to reflect excludable dividends and basis adjustments to stock held by a partnership.

Rules similar to the partnership rules apply to S corporations and their shareholders. In the case of S corporations, these amounts also increase the accumulated adjustments account of the corporation.

Distributions made by S corporations

The general provisions, as modified as described below, relating to excludable dividends, retained earnings basis adjustments, and distributions from a CREBAA apply to S corporations and their shareholders. An S corporation takes into account, in computing its EDA, the applicable income taxes imposed for a taxable year the corporation was a C corporation[28], and the tax imposed on built-in gains under section 1374. No amounts are added to an EDA by reason of excludable dividends received by, or basis adjustments allocated to, an S corporation; instead these dividends and basis adjustments flow thru to the shareholders as described above.

The items taken into account in determining the tax imposed on built-in gains under section 1374 no longer will pass through to the shareholders, so that S corporation shareholders generally will not pay a tax on the items which are taxed at the corporate level.[29] The amount of these items (determined without regard to any net operating loss from a C corporation year [30] and reduced by the amount of the tax) increases the corporation's accumulated earnings and profits.

Under regulations, distributions of excludable dividends and amounts from a CREBAA will be treated as made before distributions from the accumulated adjustments account. Thus, under the proposal, distributions by an S corporation with accumulated earnings and profits are made in the following order:

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[28] For example, the applicable income taxes imposed shown on a return filed in the final year the corporation was a C corporation or the first year the corporation is an S corporation are taken into account in computing the EDA for years the corporation is an S corporation. Any tax imposed by reason of the LIFO recapture rules of section 1363(d) will be taken into account in computing the corporation's EDA under the usual rules relating to the filing of returns and the payment of tax.

[29] The tax imposed by section 1374 will no longer pass through to shareholders as a loss sustained by the S corporation.

[30] A C corporation loss reduced the earnings and profits (or increased a deficit in earnings and profits) for the taxable year that the loss arose.

1. An excludable dividend to the extent of the EDA.

2. Reduction of basis (or recognition of gain) to the extent of the CREBAA.

3. Reduction of basis (or recognition of gain) to the extent of the accumulated adjustments account.

4. Taxable dividend to the extent of accumulated earnings and profits.

5. Reduction of basis.

6. Recognition of gain.

Treatment of passive investment income

The tax imposed on S corporation passive income is repealed. The provision terminating an S election as a result of passive income is also repealed.

Trusts and estates

The distributable net income of a trust or estate includes the excludable dividends received by the trust or estate and the distributions from a CREBAA received by the trust or estate.

Cooperatives

The EDA of a cooperative shall be allocated between shares of the corporation held by patrons and shares held by other persons as prescribed by regulations, and no deduction shall be allowed to the cooperative for any excludable dividend or distribution from a CREBAA paid to a patron.

Employee stock ownership plans (ESOPs)

Deductible dividends paid to an employee stock ownership plan ("ESOP") are not treated as dividends for purposes of applying the rules under dividend exclusion rules added by the proposal. Thus, for example, they are disregarded in determining the excludable portion of dividends paid with respect to all dividends made by the corporation. Also, stock on which a deductible dividend may be made is disregarded for purposes of allocating basis adjustments and making distributions from a CREBAA.

Private foundations

Excludable dividends and distributions from a CREBAA will not be included in the calculation of net investment income of a private foundation for purposes of the tax imposed by section 4940.

Anti-abuse rules

If a shareholder does not hold stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (as measured under section 246(c)) [31], the basis of the stock is reduced by the amount of any excludable dividends and allocated basis adjustments. Also, no deduction is allowable with respect to payments related to an excludable dividend or basis increase.

The rules of section 1059 requiring a basis reduction with respect to certain extraordinary dividends are made applicable to the excludable dividends received by, and basis adjustments allocated to, both corporate and noncorporate shareholders. Except as provided by regulations, if an excludable dividend is received, or a basis adjustment is allocated, with respect to a share of stock, the basis reduction applies to that share of stock, without regard to whether the excludable dividend or basis adjustment otherwise would be extraordinary, if received during the first year (or such other period provided by regulations) the taxpayer holds the stock.[32]

In the case of a corporate shareholder, the EDA and the earnings and profits are not increased by any amounts that result in a basis decrease under these rules.

Shareholder indebtedness

In the case of debt-financed portfolio stock held by a corporation, the excludable portion of a dividend is reduced by the average indebtedness percentage (as defined in section 246A) applicable to the stock. Also, there is included in gross income an amount equal to the basis adjustment to any stock held by the taxpayer multiplied by the average indebtedness percentage. The EDA of a corporate shareholder is not increased by any amount included in gross income by reason of this rule.

The investment interest limitations of section 163(d) for individuals apply. In addition, any excludable dividend is not investment income.

Redemptions

The present law rules relating to the treatment of redemptions of stock (either directly by a corporation or through the use of a related corporation) as a dividend or as an exchange remain the same as under present law. Redemptions treated as exchanges reduce the EDA and CREBAA by the ratable share of the amount attributable to the shares redeemed.

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[31] In the case of preferred stock, the periods are doubled.

[32] For this purpose, the holding period of stock acquired from a decedent is determined without regard to the rule otherwise providing for long-term capital gain treatment for the stock (sec. 1223(11)).

Tax-free reorganizations and liquidations

In the case of a tax-free reorganization or liquidation, the current rules providing for the carryover of tax attributes are amended to provide for the carryover of the acquired corporation's EDA and CREBAA. In the case of a tax-free spin-off, the CREBAA is divided between the distributing and controlled corporations in accordance with regulations provided by the Secretary of the Treasury.

Rights to acquire stock

The Secretary of the Treasury may promulgate regulations treating the holder of a right to acquire stock as the holder of stock and regulations amending the option attribution rules.

Alternative minimum tax

Excluded dividends and reduced gain (or increased loss) resulting from the allocated basis adjustments are not an item of tax preference or adjustment for purposes of determining alternative minimum taxable income (including the determination of adjusted current earnings for corporations).

Accumulated earnings tax and personal holding company tax

The accumulated earnings tax and the personal holding company tax are repealed, for taxable years beginning after December 31, 2002, except that any deficiency dividend or dividend paid on or before the 15^{th} day of the third month after the close of the taxable year which is taken into account in computing the tax for a taxable year beginning before that date may be made. Such a dividend is not treated as a dividend for purposes of applying the dividend exclusion rules of the proposal.

Compliance

Form 1099 will be revised to provide information to shareholders to indicate the amount of excludable dividends and the amount of basis adjustments and the date they are allocated.

A corporation will calculate the EDA and CREBAA and report those amounts to the IRS annually on its income tax return.

Regulations

The Secretary of the Treasury is provided authority to prescribe appropriate regulations to carry out these provisions.

The Secretary of the Treasury may amend the consolidated return regulations (effective as of the effective date of the proposal) to properly account for an EDA of a member of the group, for basis adjustments allocated to a member of the group, and for CREBAA distributions received by a member of the group. These regulations may accelerate the inclusion in the excludable dividend amount with respect to activities of lower-tier members of the group, excludable dividends received from lower-tier members, and increases in basis allocated to stock in lower tier members.

Effective Dates

In general

The proposal applies to distributions (and basis adjustments) made after December 31, 2002, with respect to taxes paid for taxable years ending on or after April 1, 2001. Thus, for example, a calendar year corporation that filed its 2001 federal income tax return and paid tax on September 15, 2002, may pay excluded dividends or allocate basis adjustments beginning January 1, 2003, based on the amount of tax paid with respect to its taxable income for 2001.

Dividends-received deduction

The present law dividends received deduction continues to apply to distributions (not otherwise treated as excludable dividends) of earnings and profits accumulated in taxable years ending before April 1, 2001, that are distributed before January 1, 2006, with respect to stock issued before February 3, 2003.

Repeal of accumulated earnings tax, personal holding company tax and tax on passive income of S corporations.

These taxes are repealed for taxable years beginning after December 31, 2002.

S corporation tax on built-in-gains

The provisions relating to the tax on the built-in gains of S corporations (section 1374) are effective for taxes imposed in taxable years beginning after December 31, 2002.[33]

Analysis

Policy issues

In general

Under present law, the United States has a "classical" system of taxing corporate income. Under this system, corporations and their shareholders are treated as separate persons. A tax is imposed on the corporation on its taxable income, and after-tax earnings distributed to individual shareholders as dividends are included in the individual's income and taxed at the individual's tax rate. This system creates the so-called "double taxation of dividends." The President's proposal would replace the classical system with an integrated system, allowing shareholders to exclude dividends to the extent taxed to the corporation. This is intended to reduce economic distortions.

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[33] This effective date prevents a change in the taxation of S corporation shareholders for taxable years beginning before January 1, 2003.

The present system, it is argued, results in economic distortions. Economically, the issue is not that dividends are taxed twice, but rather the total tax burden on income from different investments. Business investments in entities not subject to corporate tax, such as partnerships, limited liability companies, and S corporations generally are taxed more favorably. An investment in a C corporation that returned $100 would pay a $35 corporate income tax and then, if the remaining $65 were paid out as a dividend to a shareholder in the highest individual income tax bracket (presently 38.6 percent[34]), the shareholder would net $39.91. Had the investment been made through a partnership, the taxpayer would have received $61.40 ($100 - ($100 multiplied by 38.6 percent)) after tax. Thus, proponents of integration observe that because the present tax system creates different after-tax returns to investments undertaken in different legal forms that the choice of legal entity is distorted and economic efficiency is reduced.

Proponents of integration argue that present law distorts corporate financial decisions. They argue that because interest payments on the debt are deductible, present law encourages corporations to finance using debt rather than equity. They observe that the increase in corporate leverage, while beneficial to each corporation, may place the economy at risk to more bankruptcies during an economic downturn.

In addition, proponents of the proposal argue that present law encourages corporations to retain earnings rather than to distribute them as taxable dividends. Drawing on the example above, if the corporation had retained the $65 of after-corporate income tax income, the value of the corporation should increase by $65. If shareholders sold their shares, under present law they would recognize the $65 as a capital gain and generally incur a $13 income tax liability. Thus, a retention policy could result in net income to the shareholder of $52 as opposed to $39.91 if income were paid out as a dividend.[35] This difference in effective tax burden may mean that shareholders prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings. This is another source of inefficiency as the opportunity to earn higher pre-tax returns is passed up in favor of lower pre-tax returns.

The proposal would narrow the difference in effective tax burden between a policy of dividends and a policy of retaining earnings. Continuing the example above, if a company's policy is to pay out all net income as a dividend, it earns $100, pays $35 in corporate income tax, pays $65 to shareholders who have excludable dividends and pay no additional tax. The net return to shareholders is $65. If the company's policy is to retain all net income, it earns $100 and pays $35 in corporate income tax. Under the proposal, it retains $65 and reports to

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[34] A separate provision of the President's budget proposal would provide that the highest marginal tax rate for individuals would be 35 percent for 2003 and beyond.

[35] In practice the effective tax rate difference between the dividend policy and retention policy would be greater. This simple example assumes the capital gain is recognized immediately. Taxpayers can choose to defer recognition of gain. By deferring gain, the effective tax burden on the gain declines.

shareholders that they have a $65 basis adjustment. The value of the company increases by $65 held in cash. If shareholders sell, because of the basis adjustment, they have no capital gain. The net return to shareholders is $65. The shareholder's net position is the same whether the earnings are paid out as a dividend or retained.

By reducing the aggregate tax burden on investments made by corporations, the proposal would lower the cost of capital needed to finance new investments and may increase investment in the aggregate as well as investment by C corporations. Increased investment ultimately should lead to increased labor productivity, higher real wages, and increased long term economic growth. However, the effects of tax cuts for business expenditures on investment are the subject of controversy. There is a long-standing dispute in the economics profession as to whether tax reductions for capital spending--such as the availability of accelerated methods of depreciation or investment tax credits--have any substantial impact on investment expenditures.[36] These investment incentives reduce the cost of capital, but there is no consensus about the responsiveness of investment to changes in the cost of capital.

The simple examples used above to illustrate potential sources of economic inefficiency may overstate the aggregate tax burden on investments made by C corporations. Critics of the proposal have questioned whether there will be a substantial effect on corporate investment because persons not subject to the individual income tax (e.g., foreign persons and tax-exempt institutions such as pension funds) hold substantial amounts of corporate equity. If these shareholders are the providers of incremental investment funds, the proposal generally does not change the aggregate tax burden on an investment made by a C corporation. Critics of the proposal observe that, in the early years, much of the tax reduction will accrue to returns to investments made by C corporations in the past and are not targeted at new investment.

Tax incentives

Under present law, a number of tax incentives are provided to encourage corporate investment. These incentives may take the form of exclusions, deferral of income, or credits against tax. Exclusion incentives include items such as tax-exempt interest on state and local bonds, and percentage depletion for minerals. Deferral incentives include items such as accelerated depreciation and deductions for intangible drilling expenses and mining expenses. Credits include such items as the research credit, jobs credits, low-income housing credit, energy credits, and other business tax credits. Under the President's proposal, the benefit of these incentives does not flow through to shareholders. To the extent these incentives reduce the corporate income tax, they reduce the amount of dividends otherwise eligible for the exclusion or the amount of possible basis adjustments. Thus, under the proposal, the portion of the

[36] For example, *see* Dale W. Jorgenson, "Econometric Studies of Investment Behavior: A Survey," *Journal of Economic Literature*, Vol. 9, December 1971; and Robert Eisner, "Econometric Studies of Investment Behavior: A Comment," *Economic Inquiry*, Vol. 12, 1974, pp. 91-103. Also, *see*, Alan J. Auerbach and Kevin Hassett, "Investment, Tax Policy, and the Tax Reform Act of 1986," in Joel Slemrod, editor, *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, (Cambridge, MA: The MIT Press, 1990), for a discussion of factors that make it difficult to discern the effects of tax policy on investment.

corporation's earnings that are taxed at the corporate level is taxed at the corporate tax rate, and the portion of the earnings that are not taxed at the corporate level is taxed at the shareholder's tax rate if distributed (or, at the shareholder's capital gain tax rate, when the stock is sold). Likewise, for those corporations that engage in tax sheltering activities, the benefit of these incentives may not flow through to shareholders.

The extent to which the proposal diminishes the benefit of corporate level tax incentives depends, in part, on the financial policy of the corporation. Continuing the preceding example, assume that the investment that the corporation makes which returns $100 is eligible for a $35 tax credit. Consider first the corporation that maintains the policy of paying out all net income as a dividend. The corporation earns $100. The corporation would have a $35 tax liability, but can claim a $35 credit, so pays no corporate income tax. It pays $100 to shareholders who pay $38.60 in individual income tax. The net return to shareholders is $61.40. Under the proposal, the corporation earns $100. The corporation would have $35 tax liability, but can claim $35 credit, so pays no corporate income tax. The corporation pays $100 to shareholders. These dividends are not excludable and shareholders pay $38.60 in individual income tax. The net return to shareholders is $61.40. In this case, the entire benefit of the credit is lost. The shareholders would receive the same net return ($61.40) regardless of whether the corporation earned the $100 from a credit eligible investment or another investment.

Consider the corporation that maintains the policy of retaining all net income. Under present law, the corporation earns $100. The corporation has a $35 tax liability, but can claim $35 credit, so pays no corporate income tax. The corporation retains $100. The value of the company increases by $100 held in cash. Shareholders sell and have a $100 capital gain, taxed at 20 percent, for an individual income tax of $20. The net return to shareholders is $80.[37] Under the proposal, the corporation earns $100. The corporation has a $35 tax liability, but can claim a $35 credit, so pays no corporate income tax. The corporation retains $100. There is no basis adjustment to the shareholder because no corporate income tax was paid. The value of company increases by $100 held in cash. Shareholders sell and have a $100 capital gain, taxed at 20 percent, for an individual income tax of $20. The net return to shareholders is 100 - 20 = $80.[38] Table 6, below, summarizes the results of the numerical example.

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[37] In practice the present value of the net return to shareholders would be greater than $80. This simple example assumes the capital gain is recognized immediately. Taxpayers can choose to defer recognition of gain. By deferring gain, the effective tax burden on the gain declines.

[38] In practice the present value of the net return to shareholders would be greater than $80. This simple example assumes the capital gain is recognized immediately. Taxpayers can choose to defer recognition of gain. By deferring gain, the effective tax burden on the gain declines.

Table 6.–Summary of Example of the After-Tax Return to Shareholders to a Corporate Investment that Returns $100

	$100 of Corporate Income With No Tax Credit		$100 of Corporate Income With a $35 Tax Credit	
	Present Law	**Proposal**	**Present Law**	**Proposal**
Corporation Pays Out All Income as a Dividend	$39.91	$65.00	$61.40	$61.40
Corporation Retains All Income	$52.00	$65.00	$80.00	$80.00

For a corporation that pays out all income as a dividend, the proposal removes all of the benefit of the credit eligible investment compared to a credit-ineligible investment. In fact, in this example, the proposal more than removes the benefit ($61.40 net return for the credit eligible investment under the proposal compared to $65.00 net return for the credit ineligible investment) because the individual shareholder's marginal tax rate is greater than the corporate marginal tax rate.[39] For a corporation that retains all of its income, the proposal does not alter the after-tax return to shareholders from the credit-eligible investment, and the after-tax return remains superior to the investment in the credit-ineligible investment ($80 versus $65). However, under present law, the after-tax returns were $80 for the credit-eligible investment and $52 for the credit-ineligible investment. The proposal reduces the relative attractiveness of the credit-eligible investment.

More generally, the calculations of the example for the corporation that retains all of its income, are not the result of the policy of retention, but rather that the individual taxpayer paid tax at a rate of 20 percent on corporate-source income. As noted above, this simple example looks only at the case where the shareholder is in the 38.6 percent marginal tax bracket under present law while, in fact, many shareholders are exempt persons or are in tax brackets less than 38.6 percent. Thus, if the average marginal tax rate of all corporate shareholders were 20 percent, the last row of Table 6 would calculate the returns for the investment in the credit ineligible investment and the credit eligible investment under present law and under the proposal. The proposal reduces the relative attractiveness of the credit-eligible investment for such an average shareholder.

Tax-exempt shareholders

Under the proposal, tax-exempt shareholders, such as retirement plans, including 401(k) plans and IRAs, continue to be tax-exempt. Thus, as under present law, taxable income earned by a corporation owned by tax-exempt shareholders would continue to be taxed at the corporate level. This achieves a result comparable to the imposition of the unrelated business income tax

[39] A separate provision of the President's budget proposal would provide that the highest marginal tax rate for individuals would be 35 percent for 2003 and beyond. If the taxpayer's marginal tax rate under the individual income tax were 35 percent, the returns would be $65 for both the credit eligible and credit ineligible investments.

on unincorporated business owned by tax-exempt shareholders. However, it reduces the relative benefit of the tax-exemption on dividends provided by present law since taxable shareholders also would pay no tax on excludable dividends. Under the proposal, tax-exempt persons, who presently own significant amounts of corporate stock, may find it more attractive to hold assets, such as bonds or other debt, that generate fully taxable income.

Foreign shareholders

Under the proposal, foreign shareholders continue to be taxed under current law. Withholding taxes on dividends will continue to apply, except to the extent reduced by treaties with foreign countries. The proposal is not neutral with respect to the source of investment funds. That is, the proposal generally would not change the after-tax return to investment by foreign persons. Therefore, some observe that to the extent that foreign persons are an important source of marginal investment capital there would be no incentive to increase aggregate investment in the United States.

Foreign source income

The proposal allows U.S. corporations to flow through the benefit of foreign taxes paid or accrued to the extent they are allowed a foreign tax credit under present law. Some argue that this provides a benefit to overseas investment by U.S. corporations. However, the foreign tax credit only relates to taxes paid abroad. As under present law, the proposal does not change the effective aggregate corporate level tax liability dependent upon whether the income was earned domestically or abroad.

Coordination with AGI phase-outs

Excluded dividends will not be taken into account in applying the various provisions that phase-out benefits based on an individual's income level. In the case of the computation of the tax on social security benefits, tax-exempt interest on State and local bonds is presently included in the computation of the taxpayer's modified adjusted gross income. Under the proposal, excluded dividends will not be included, resulting in a tax advantage for dividends over tax-exempt interest in certain cases.

Complexity issues

Shareholder complexity issues

Individuals will receive 1099s indicating the amount of dividends eligible for the exclusion and will exclude those amounts when they file their individual Federal income tax returns. In addition, the 1099s will indicate the amount of any basis adjustments (both increases for allocated basis adjustments and decreases attributable to distributions from a CREBAA) that are to be made to stock held by the individual shareholder. The shareholder must know the amount of the basis adjustments to a particular share of stock for all taxable years, in order to compute gain or loss when the stock is sold. The proposal requires increased record keeping by individual taxpayers and the error rate for reporting taxable dividends and calculating income from capital gain realizations would be expected to increase.

Pass-through entities, such as RICs, REITs, partnerships, S corporations, common trust funds, and trusts, will need to inform their equity owners the amount of excluded dividends and basis adjustments that passes through.

Corporate complexity issues

Under the proposal, most of the record keeping will take place at the corporate level. Corporations will compute the amount in the EDA for a year based on the tax paid and shown on the return for a particular calendar year, and based on the excluded dividends and basis adjustments it received. The corporation will then compute the percentage of dividends paid during the year that may be excluded by the shareholders.

In order to compute the EDA, the proposal generally limits refunds and credits of overpayments to the tax previously paid in the calendar year and to the amounts that produced the EDA for the current year. This limitation applies both to loss and credit carrybacks as well as overpayments arising by reason of the taxpayer simply overpaying a tax. This limitation is imposed for administrative reasons so that shareholders are not required to file amended returns to reflect the reduction in the corporate tax. However, it will limit the availability of refunds and require corporations with overpayments to establish to the Internal Revenue Service the amount that may be refunded or credited currently.

Corporations also will allocate basis adjustments to shareholders and determine the allocation of amounts to classes of stock eligible for the basis adjustments. They will keep an account of cumulative basis adjustments (CREBAA). When distributions are paid in excess of the EDA, corporations will notify shareholders the extent to which they are paid from the CREBAA. Corporations will determine the allocation of distributions from a CREBAA among various classes of stock.

A foreign corporation with no connection to the United States other than the fact it receives dividends from one or more U. S. corporations and has U. S. shareholders will need to maintain these accounts and make the computations and allocations if it wishes to pay its shareholders excludable dividends or allocate basis adjustments to its shareholders. The Internal Revenue Service will need to monitor compliance even though these corporations (and their controlling shareholders) may not be subject to the jurisdiction of the IRS.

The repeal of the accumulated earnings tax, the personal holding company tax, and the tax on S corporations having passive income will reduce complexity since corporations will no longer need to determine if they may be subject to these taxes and, in the case of the accumulated earnings tax and the personal holding company tax, whether dividends should be paid to avoid the imposition of these taxes.

Prior Action

No prior action.

E. Increase Section 179 Expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179).[40] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. An election to expense these items generally is made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with the consent of the Commissioner.[41] In general, taxpayers may not elect to expense off-the-shelf computer software.[42]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Description of Proposal

The proposal provides that the maximum dollar amount that may be deducted under section 179 is increased to $75,000 for property placed in service in 2003 and thereafter. In addition, the $200,000 amount is increased to $325,000 for property placed in service in 2003 and thereafter. Both of these dollar limitations are indexed annually for inflation. The proposal also includes off-the-shelf computer software as qualifying property. The proposal permits taxpayers to make or revoke expensing elections on amended returns without the consent of the Commissioner.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2002.

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[40] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400(f)) or an empowerment zone (sec. 1397A).

[41] Section 179(c)(2).

[42] Section 179(d)(1) requires that property be tangible to be eligible for expensing; in general, computer software is intangible property.

Analysis

Policy issues

The effect of the proposal is to expand taxpayer-favorable expensing for small business. Proponents of the proposal argue that small business is an important source of economic growth and job creation in the United States. By reducing the cost of capital through expansion of the benefits of section 179, small business investment may increase. Proponents also observe that by reducing current tax liabilities, an increase in section 179 expensing can increase a small business's cash flow. They note that cash flow often is an important determinant of investment by small business, so increased investment is likely to result even for firms that make investments in excess of $75,000 annually.[43]

Opponents argue that the major determinant of investment by small firms is demand for the firm's product. Opponents of the proposal might argue that this additional tax incentive is not needed to promote capital investment. They might argue that nontax factors such as a reduction in interest rates would have a more direct stimulative effect on investment. Opponents argue that increasing expensing under section 179 may have little effect on incremental investment decisions, as the cost of capital only is reduced for annual investments at a level between the present-law $25,000 limitation and the proposed $75,000 limitation. They further note that the investment incentive does not apply equally to all small businesses. More capital intensive small businesses may receive no benefit under the proposal because they exceed the proposed $325,000 phaseout limitation. They argue that providing expensing for some, but not all businesses, distorts investment decisions in the economy.

With respect to including off-the-shelf computer software as section 179 property, proponents may argue that such software has a short period of utility as a practical matter because of frequent changes in computer software, so that it is appropriate to expense it. Opponents may argue that such software is more properly viewed as an intangible asset and that a change to permit expensing should only be undertaken as part of a broader review of expanding section 179 to intangible property. Consequently, it should be subject to the cost recovery rules applicable to intangible assets, not to tangible assets.

Complexity issues

Proponents of the proposal argue that increasing the dollar amount of investment under section 179 to $75,000 has a simplifying effect. The increased amount of investment that may be expensed means that in some cases, taxpayers need not keep depreciation schedules, which may potentially simplify audits. Proponents of the proposal may also argue that indexing the dollar amounts under section 179 ensures that the incentive effect of the provision is not diluted by inflation as time passes.

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[43] *See*, R. Glenn Hubbard, "Capital- Market Imperfections and Investment," *Journal of Economic Literature*, 36, March 1998. Hubbard reviews economics literature that identifies an empirical link between cash flow and investment for certain firms. Hubbard also reviews the literature on the theory that might explain such empirical observations.

Opponents of the proposal may argue that not all small businesses would experience a simplification benefit from increasing the dollar amount of investment to $75,000, because the composition and total costs of business assets vary. Opponents of the proposal may also argue that annual increases in the allowable dollar amounts attributable to indexing could create confusion among taxpayers.

Proponents of the proposal may argue that allowing section 179 elections to be made or revoked on an amended return simplifies the operation of the provision for taxpayers by permitting the election or revocation for the taxable year the taxpayer invests in section 179 property. Opponents of this aspect of the proposal may argue that it could make section 179 elections more difficult to monitor for the IRS, particularly because the consent of the Commissioner is not required.

Prior Action

A proposal to increase the dollar amount of section 179 expensing to $35,000 and to increase the $200,000 amount to $325,000, applying temporarily for property placed in service in taxable years beginning before 2001 and before 2003, was included in the Economic Recovery and Assistance for American Workers Act of 2001, as approved by the Senate Finance Committee on November 8, 2001.

A proposal to increase the dollar amount of section 179 expensing to $35,000 and to increase the $200,000 amount to $325,000, applying temporarily for property placed in service in taxable years beginning before 2001 and before 2004, was included in the Economic Security and Recovery Act of 2001, as approved by the House Ways and Means Committee on October 17, 2001.

A proposal to increase the dollar amount of section 179 expensing to $25,000 (it was then $20,000), to substitute a “small business” limitation for the $200,000 limitation, to permit a section 179 election to be revoked on an amended return, and to make other changes to section 179, was included in President Clinton’s Fiscal Year 2001 Budget Proposal.

A proposal to increase the dollar amount of section 179 expensing to $30,000 for taxable years beginning in 2000 and thereafter was included in the Taxpayer Refund and Relief Act of 1999, as passed by the Congress and vetoed by President Clinton.

II. TAX INCENTIVES

A. Provisions Related to Charitable Giving

1. Charitable contribution deduction for nonitemizers

<u>Present Law</u>

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.[44]

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.[45] 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.[46]

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

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

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

[46] Sec. 6115.

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. The threshold amount for 2003 is $139,500 ($69,750 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 2003.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2002.

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.[47] 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.[48] Thus, the proposal would provide nonitemizers with a direct tax incentive to make charitable

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

[48] 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.

contributions by reducing the tax price of giving. However, the proposal would cap the nonitemizer deduction at an applicable amount. The tax price of giving is only reduced for contribution amounts below the cap. Nonitemizers who give greater amounts to charity do not face a reduced tax price for additional giving until it becomes advantageous for them to itemize deductions. In addition, in some cases, taxpayers could find it beneficial to reduce charitable donations.[49]

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.[50] In addition, most studies rely upon data relating to taxpayers who itemize deductions. Inferences drawn from such studies may be inappropriate when applied to taxpayers

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[49] Take, for example, a taxpayer who finds it beneficial to itemize all qualifying deductions under present law but who, under the proposal, would find it more beneficial to claim the standard deduction and additional deduction for charitable contributions (e.g., a taxpayer with more than $250 in charitable contributions and total other qualifying itemized deductions that are less than the standard deduction plus $250). In such a case, the proposal reduces the incentive to make additional charitable contributions and also could encourage a taxpayer to reduce contributions to $250 (assuming the tax incentive was a determinative factor for gifts over $250). 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.

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

who currently claim the standard deduction. Some evidence suggests that higher-income taxpayers are more responsive to the incentives provided by the tax deduction.[51]

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.[52]

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

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

The tax deduction for charitable contributions sometimes is referred to as a tax expenditure in that it may be considered to be analogous to a direct outlay program that would direct Federal funds to charitable organizations. Applying this analogy, the tax deduction for

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

[52] 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.*

charitable contributions is most similar to those direct spending programs that have no spending limits,[53] 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 7 below offers some indirect evidence on the magnitude of such giving. The second column of Table 7 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 7 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 $17.5 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 7 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.[54] 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.[55] 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.

[53] 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.

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

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

Table 7.–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	121.97	95.82
1998	135.75	109.24
1999	152.61	125.80
2000	158.93	141.48
2001	160.72	n.a.

[1] Giving USA 2002. 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.
n.a. - not available.

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."[56] On the other hand, the proposal could

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

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 (in the case of a joint return in 2003, greater amounts in later years as described above) would receive more tax benefit if they claimed the standard deduction, provided they have charitable contributions at least equal to the amount by which their total deductions exceed the standard deduction. By switching to the standard deduction, such taxpayers would no longer have to itemize deductions (other than the nonitemizer charitable deduction). However, any potential itemizers who choose to take the standard deduction as a result of these calculations would still need to keep records of potential itemized deductions in order to make the calculation, and thus simplification benefits are diminished.

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

Prior Action

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

H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, included a charitable nonitemizer deduction that provides a deduction of the lesser of (1) the amount allowable to itemizers as a charitable deduction for cash contributions and (2) an applicable amount. The applicable amount is $25 ($50 in the case of a joint return) in 2002 and 2003, $50 ($100 in the case of a joint return) in 2004 through 2006, $75 ($150 in the case of a joint return) in 2007 through 2009, and $100 ($200 in the case of a joint return) in 2010 and thereafter.[57]

The "CARE Act of 2003," as marked up by the Senate Finance Committee on February 5, 2003, contains a similar proposal that would provide a deduction for aggregate cash contributions over $250 and up to $500 ($500 and $1,000 respectively if married filing a joint return) for taxable years beginning after December 31, 2002, and taxable years beginning before January 1, 2005.

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[57] 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.

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

Present Law

In general

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

Charitable contributions

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

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[58]

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.[59] 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.[60]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations

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

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

[60] Sec. 6115.

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 2003 is $139,500 ($69,750 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.[61] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[62] 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

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

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

may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are 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;[63] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

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

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 would apply only to the extent the individual does not receive any benefit in exchange for the transfer. Amounts transferred directly from the IRA to the qualified charitable organization 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.

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

Effective date.–The proposal is effective for distributions after December 31, 2002.

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 would 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

The President's fiscal year 2002 and 2003 budget proposals included a similar proposal, except that the exclusion would have applied only to distributions made after the IRA owner reached age 59-1/2.

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 to distributions only once the IRA owner reached age 70-1/2. 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 applied only to transfers made on or after the date the IRA owner attains age 59-1/2.

The "CARE Act of 2003," as marked up by the Senate Finance Committee on February 5, 2003, contains a similar proposal 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 70-1/2, or (2) to a split-interest entity on or after the date the IRA owner attains age 59-1/2.

3. 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.[64]

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

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.[65]

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 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, 2002.

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

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.[66]

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

[66] *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).

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 good 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.[67]

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[67] 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;
- 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.

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.[68] 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.

<u>Complexity issues</u>

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

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(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.

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

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.[69] 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 budget proposal contained a similar proposal to the current proposal.

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

The "CARE Act of 2003," as marked up by the Senate Finance Committee on February 5, 2003, contains a similar proposal.

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)[70] 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

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[69] 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.

[70] Sec. 4942(g).

immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[71] 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.[72]

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.[73]

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 distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.[74]

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, 2002.

[71] Sec. 4940(e).

[72] Sec. 4942.

[73] 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).

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

Analysis

Policy issues

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.[75] 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 to charities.[76] 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

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

[76] 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.

substantially.[77] 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.[78] 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 average, thereby increasing the likelihood the foundation's net investment income is taxed at the two-percent rate, rather than the one-percent rate.[79]

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

[77] *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.

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

[79] 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.

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.[80] 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.[81] 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.[82]

Critics of the present-law excise tax structure observe that the median payout rate of large nonoperating private foundations (foundations with total assets of $50 million or more) was 5.1 or 5.0 percent in each year from 1991 through 1995 and was 5.0 percent in 1999.[83] 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.[84] Critics of the present-law excise tax structure argue that these data suggest that the excise tax structure is not encouraging any noticeable increase in payout rates.

Complexity issues

The proposal 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,

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[80] 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.

[81] *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.

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

[83] *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.

[84] Id.

as they would not have to compute a five-year average of charitable distributions on the information return they file each year.

Prior Action

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

The President's fiscal year 2003 budget proposal included an identical 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.[85]

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.[86]

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

[85] Sec. 664(d).

[86] Sec. 664(b).

distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[87]

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, 2002, regardless of when the trust was created.

Analysis

Policy issues

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

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

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

Complexity issues

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 substantially similar proposal was included in the President's fiscal year 2003 budget proposal.

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.

The "CARE Act of 2003," as marked up by the Senate Committee on Finance on February 5, 2003, contained an identical proposal.

6. 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.[88] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[89] 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.[90]

Effective date.–The proposal applies to taxable years beginning after December 31, 2002.

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

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

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

Analysis

Policy issues

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.

Complexity issues

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

Prior Action

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

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, as reported by the Senate Committee on Finance on July 18, 2002, included a similar proposal.

The "CARE Act of 2003," as marked up by the Senate Committee on Finance on February 5, 2003, contained a similar proposal.

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 included 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") when 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. Under prior law, 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 Taxpayer Relief Act of 1997 ("1997 Act") repealed the $150 million limit for bonds, issued after the date of its enactment, to finance capital expenditures incurred after the date of enactment (August 5, 1997).

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 this provision of the 1997 Act applies only to bonds issued with respect to capital expenditures incurred after the date of enactment, 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 before the date of enactment, or new-money bonds for capital expenditures incurred before that 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 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. In commenting on the repeal of the $150 million limit, the Senate Finance Committee report asserted that it wanted 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.[91]

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

Although the conference report on that legislation noted the continued applicability of the $150 million limitation to refunding and new-money bonds, no reason was given for retaining the rule.[92] 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.

<u>Prior Action</u>

No prior action.

8. Repeal Restrictions on the Use of Qualified 501(c)(3) Bonds for Residential Rental Property

<u>Present Law</u>

<u>In general</u>

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 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.

<u>Qualified residential rental projects</u>

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

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

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,[93] 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.

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

[93] 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.

> 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.[94]

In conference, the applicability of the low-income tenant rules was limited to the acquisition of existing property.[95] 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.

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

No prior action.

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[94] 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.*

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

B. Education Provisions

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

Present Law

The No Child Left Behind Act of 2001[96] amended the Elementary and Secondary Education Act of 1965 to provide that Federal grant funds may be used by local educational agencies to provide supplemental educational services, such as tutoring and summer school, to children enrolled in a public school "identified for school improvement" for two consecutive years. A school is identified for improvement after failing to make "adequate yearly progress" for two consecutive years under standards established by State law. If a school is identified for improvement, local educational agencies must (unless prohibited by State law) provide students enrolled at such a school the option to transfer to another public school within the jurisdiction of the local educational agency, including a public charter school. The local educational agency is required to provide transportation to students who request such a transfer. A student who transfers is permitted to remain at the new school through such school's highest grade; however, the local educational agency is not required to provide transportation if the student's original school has improved to make adequate yearly progress. Federal funds generally may not be used to pay the costs of attending a private school.

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 education expenses" of a designated beneficiary.[97] Contributions to Coverdell education savings accounts may be made only in cash. Annual contributions to Coverdell education savings accounts may not exceed $2,000 per beneficiary (except in cases involving certain tax-free rollovers) and may not be made after the designated beneficiary reaches age 18.

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

If the qualified education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from a Coverdell education savings account, then the qualified education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable from gross income (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

[96] Pub. L. No. 107-110 (2001).

[97] Sec. 530.

income. The earnings portion of a distribution from a Coverdell education savings account that is includible in income also generally is subject to an additional 10 percent tax.

Qualified education expenses include expenses for both higher education and elementary and secondary school.[98] Qualified elementary and secondary school expenses include expenses for: (1) tuition, fees, academic tutoring, special need services in the case of a special needs beneficiary, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items and services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of computer technology or equipment or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software designed for sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

Description of Proposal

The proposal provides a refundable tax credit for expenses incurred in connection with a student's transfer from a failing public school to a different public school in another jurisdiction or to a private school. Specifically, the proposal provides an annual credit for 50 percent of the first $5,000 of a taxpayer's qualifying educational expenses incurred with respect to a qualifying child's attendance at a qualifying school as a qualifying student. The annual credit of up to $2,500 per qualifying student per year is available for each year the student is a qualifying student. The credit is allowable for more than one qualifying child and applies against both regular and alternative minimum tax. Taxpayers claiming the credit are required to provide the name and taxpayer identification number of the qualifying student and the name and address of the local school that the student normally would have attended. In addition, taxpayers are required to keep records of qualifying expenses.[99]

Qualifying expenses are tuition and required fees, transportation expenses,[100] and certain other expenses, including expenditures for academic tutoring, special needs services in the case

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[98] Qualified higher education expenses are defined to mean tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, expenses for special needs services in the case of a special needs beneficiary, and reasonable costs for room and board for students who are at least half-time students. Secs. 530(b)(2)(A)(i) and 529(e)(3).

[99] Local educational agencies are asked to include an explanation of the availability of the credit as part of the dissemination of annual reviews.

[100] If a taxpayer's car is used to provide transportation, the expenses are limited to the cost-per-mile allowed in connection with the use of a car for charitable activities.

of a special needs student, books, supplies, computer technology and equipment, room and board, uniforms, and supplementary items and services (including extended day care programs) that are required or provided by the school. Tuition or required fees paid to a public school within the jurisdiction of the local education agency in which the failing school is located do not qualify. Qualified elementary and secondary education expenses for purposes of Coverdell education savings accounts also qualify, but the taxpayer cannot claim the credit and treat the expenses for which the credit was claimed as qualifying distributions from the Coverdell education savings account. In the case of a qualified school that is a home school (as defined by State law), qualifying expenses include expenditures for academic tutoring, special needs services in the case of a special needs student, books, supplies, and computer technology and equipment. In general, a credit is allowed only for payments of qualified expenses for an academic period beginning in the same taxable year as the year the payment is made.[101]

A qualifying child is a child who has the same principal place of abode as the taxpayer for more than one-half of the taxable year and is the taxpayer's son, daughter, stepson or stepdaughter, or a sibling or stepsibling of the taxpayer (or descendant of a sibling or stepsibling of the taxpayer) who the taxpayer cares for as the taxpayer's own child. An eligible foster child within the meaning used for purposes of the earned income tax credit also qualifies.[102]

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

A qualifying school is any public school (other than the local school), including a public charter school, making adequate yearly progress in the prior year or a private elementary or

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

[102] *See* sec. 32(c)(3)(B)(iii).

secondary school located in the United States. The definition of school is determined under the applicable State law.

Effective date.–The proposal is effective with respect to expenses incurred beginning with the 2003-2004 school year and through the 2007-2008 school year.

Analysis

Policy issues

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

Others might argue that the proposal does not address how resources could be better spent on public schools, and therefore does not lead to overall reform of the public school system. Others also argue that the proposal could lead to abuse by taxpayers who enrolled a qualifying child in a local school solely for the purpose of obtaining the tax credit and then transferring the child to a private school. Others also note that the proposal is available to taxpayers at all income levels and that it is not appropriate for the Federal Government to provide a credit to those who can afford to send a child to a different school. Also, some might argue that the amount of the credit is not enough to enable low-income parents to send their children to other schools, so those most in need of assistance in securing a good education for their children will not benefit from the credit. A related issue is the effectiveness of the education provisions underpinning the proposal. That is, if the education provisions do not adequately identify schools as failing or succeeding, then the credit would be less effective. The proposal also may raise a question of constitutional law to the extent that some of the private schools benefiting from the subsidy are religious schools.[103] In addition, some argue that home schools should not be supported by Federal subsidy, even if defined as a school under State law.

Complexity issues

The proposal adds a new and complex tax credit to the Code. The proposal contains a number of defined terms -- qualifying child, qualifying student, qualifying expenses, and qualifying school -- that generally are more narrowly defined than under various present-law meanings of the terms in other contexts, thus multiplying the potential for taxpayer uncertainty

[103] *See, e.g.*, *Zelman v. Simmons-Harris*, 536 U.S. 639 (2002) (upholding a pilot program established to provide educational choice to families by providing tuition aid for students to attend a participating public or private school of the parent's choosing and tutorial aid for students who chose to remain enrolled in public school).

and likely decreasing administrative efficiency. In addition, the definition of qualifying expenses presents another version of what constitutes "qualified" educational expenses to a tax Code that already contains multiple definitions.[104] The same is true for the definition of qualifying child, which has five varying definitions under present law.[105] Taxpayers need to determine whether a taxpayer's educational expenses meet the requirements of more than one tax benefit (e.g., the proposal and a qualifying distribution from a Coverdell education savings account), and if so, which provision provides the better benefit. Accordingly, the proposal increases the transactional complexity for taxpayers choosing among education benefits. Taxpayers claiming the credit are required to substantiate qualifying expenses, which may increase the record keeping burden on taxpayers. To administer the proposal properly, the IRS would need to create new tax forms and verify that schools are not making adequate yearly progress.

Prior Action

A similar proposal was included in the President's fiscal year 2003 budget proposal.[106]

2. 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

Section 62 provides for an above-the-line deduction of up to $250 of expenses incurred by an eligible educator in connection with 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 educator in the classroom.[107] An eligible educator means, with respect to any taxable year, an individual who is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. For this purpose, a school means any school that provides elementary education or secondary education (kindergarten through grade 12), as determined under State law. This above-the-line deduction is available for taxable years beginning during 2002 or 2003.[108]

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

[105] *Id.*, at 44-66.

[106] The President's fiscal year 2003 proposal was identical, except that it would have been effective with respect to expenses incurred beginning with the 2002-2003 school year and through the 2006-2007 school year.

[107] Secs. 62(a)(2)(D) and (d), added by P.L. No. 107-147, secs. 406(a) and (b) (2002).

[108] The above-the-line deduction applies only to expenses that are otherwise deductible under section 162 as trade or business expenses. The deduction is allowed only to the extent the

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.[109] Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.

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.[110]

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 2003 is $139,500 ($69,750 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.

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amount of qualifying expenses exceeds the amount excludable under section 135 (relating to income from certain U.S. savings bonds), 529(c)(1) (relating to qualified tuition programs), or 530(d)(2) (relating to Coverdell education savings accounts).

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

[110] Sec. 222.

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.[111]

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 proposal makes the section 62 above-the-line deduction permanent and increases the maximum deduction to $400. Eligible expenses are expanded to include teacher training expenses related to current teaching positions. Travel or lodging expenses, or expenses related to religious instruction or activities, are not eligible expenses. Expenses claimed under the proposal cannot be claimed as itemized deductions 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 expenses as well as a certification from a principal or other school official stating that the expenses qualified.

The proposal clarifies the present-law 900-hour rule to refer to a school year ending during the taxable year.

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.[112]

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

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[111] A separate proposal contained in the President's fiscal year 2004 budget would permanently extend the elimination of the overall limitation on itemized deductions after 2010.

[112] *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).

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 sources of complexity and has recommended that such provisions be repealed.[113] 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.

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.

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[113] *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.

Prior Action

A similar proposal was included in the President's fiscal year 2003 budget proposal.[114] The President's current proposal alters the present-law above-the-line deduction to align more closely with the President's fiscal year 2003 proposal, and clarifies the application of the present-law 900-hour rule.

[114] P.L. No. 107-147, secs. 406(a) and (b), enacted a similar provision.

C. Health Care Provisions

1. Refundable tax credit for the purchase of health insurance

Present Law

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

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

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

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

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

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

Under the Trade Adjustment Assistance Reform Act of 2002,[115] 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 to be payable on an

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

advance basis pursuant to a program to be established by the Secretary no later than August 1, 2003.

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 Archer MSA for the year the credit is claimed.

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.[116] 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.

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

At the option of States, after December 31, 2004, 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, 2003. The advanced payment option is available beginning July 1, 2005.

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 benefiting from the credit will be insurers. Proponents counter that the credit level is sufficient, and that individuals who purchase insurance as a result of the credit will be better off than they would be without insurance.

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

The proposal addresses some of the present-law differences in tax treatment between employer-subsidized health insurance and insurance purchased by individuals. Critics of the proposal might argue that providing a credit for the purchase of health insurance 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 not create an incentive to leave employer-provided coverage and would make health insurance coverage more affordable and accessible. On the other hand, a spending program may provide less individual choice of health insurance options.

<u>Advanced payment mechanism</u>

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

Some argue that the mechanism for delivering the credit on an advanced basis 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.

It may also be argued that the advanced payment mechanism of the proposal is flawed because an individual could receive the credit as an advanced payment based on the prior year's income, even though ineligible for the credit because of the current year's income. Because there is no reconciliation required on the current year return, such individual 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.

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

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

Complexity issues

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

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

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

Prior Action

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

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

Present Law

Under present law, the Federal income tax treatment of qualified long-term care insurance expenses is similar to the treatment of health insurance expenses.[117] 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.[118] 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 2003): $250 in the case of an individual 40 years old or less; $470 in the case of an individual who is more than 40 but not more than 50; $940 in the case of an individual who is more than 50 but not more than 60; $2,510 in the case of an individual who is more than 60 but not more than 70; and $3,130 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.[119] 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.

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

[118] Sec. 213(d).

[119] 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.

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

In order for a long-term care insurance contract to be a qualified long-term care insurance contract: (1) the contract must be guaranteed renewable; (2) the contract generally cannot provide for a cash surrender value or other money that can be paid, assigned, or pledged as a loan or borrowed; (3) all refunds of premiums, and all policyholder dividends or similar amounts, under the contract are to be applied as a reduction in future premiums or to increase future benefits; and (4) the contract must meet certain consumer protection standards.[120] Contracts that provide for per diem or similar payments are subject to additional requirements.

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

Description of Proposal

The proposal 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 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 proposal also imposes new standards on qualified long-term care policies.[121]

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

Effective date.–The proposal is effective for taxable years beginning on or after January 1, 2004.

Analysis

Policy issues

In general

The present-law favorable tax treatment of qualified long-term care insurance contracts was adopted to provide an incentive for individuals to take financial responsibility for their long-

[120] Sec. 7702B.

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

term care needs.[122] 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 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 2004 budget proposal contains other provisions, in particular, a tax credit for the purchase of health insurance, that address the need for health insurance. In addition, some argue that an additional incentive to purchase long-term care insurance is appropriate to encourage individuals to purchase the insurance when they are younger. Premiums for long-term care insurance typically have a level payment feature; that is, part of the premium is allocated to the cost of current coverage and part to future coverage. Some argue that additional tax benefits will encourage individuals to purchase such coverage at a young enough age so that premiums are more affordable.

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

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

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.

Prior Action

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

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

Present Law

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

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

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[123] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[124] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

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[123] Sec. 401(k).

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

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[125] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[126]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to: (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage); (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year; (3) only reimburse medical expenses which meet the definition of medical care under section 213(d); (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan; (5) reimburse medical expenses which are incurred during the participant's period of coverage; and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[127]

Description of Proposal

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

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

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

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

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

Analysis

In general

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

Tax policy, efficiency and health policy issues

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

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

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

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

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

Complexity issues

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

Prior Action

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

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

Present Law

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

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

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[128] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[129] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[130] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[131]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage), (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year, (3) only reimburse medical expenses which meet the definition of medical care under section 213(d), (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan, (5) reimburse medical expenses which are incurred during the participant's period of coverage, and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[132]

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[128] Sec. 401(k).

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

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

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

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

Description of Proposal

The proposal allows up to $500 of unused amounts in an employee's health FSA to be distributed to the employee or contributed to a qualified cash or deferred arrangement ("401(k) plan"), tax-sheltered annuity ("403(b) plan"), governmental section 457 plan, SARSEP,[133] SIMPLE IRA,[134] or an Archer medical savings account ("MSA"). Amounts distributed to the employee are includible in gross income and subject to employment taxes. Amounts contributed to a 401(k) plan or similar arrangement or an Archer MSA are subject to the normal tax rules applicable to contributions to such arrangements. Thus, for example, amounts contributed to a section 401(k) plan are subject to the limit on elective deferrals and subject to the nondiscrimination rules applicable to such plans.

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

Analysis

In general

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

Tax policy, efficiency and health policy issues

Some argue that cafeteria plans in general and FSAs in particular undermine sound income tax policy because they allow employees to choose whether certain income is taxable. Such plans and arrangements, like other income tax exclusions, contribute to unfairness in the Federal tax system because they result in unequal treatment of taxpayers with the same economic income. For example, medical expenses paid or reimbursed through a cafeteria plan are excludable from gross income, whereas if such expenses are paid directly by the employee, are

[133] A SARSEP is a Simplified Employee Pension ("SEP") that has a salary reduction feature and is described in section 408(k)(6). SARSEPs were available to employers with 25 or fewer employees and were replaced by SIMPLE IRAs. No new SARSEPs can be established after December 31, 1996.

[134] SIMPLE IRAs replaced SARSEPs. A SIMPLE IRA is an IRA to which salary reduction contributions can be made. SIMPLE IRAs are described in section 408(p).

deductible only if the employee itemizes deductions and only if the employee's total medical expenses exceed 7.5 percent of adjusted gross income. Thus, a taxpayer who is covered by a cafeteria plan may have lower tax liability that a similarly situated taxpayer who is not covered by such a plan.

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

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

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

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

Complexity issues

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

Prior Action

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

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

Present Law

In general

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

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[135] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

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

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

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[135] 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.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,700 and no more than $2,500 in the case of individual coverage and at least $3,350 and no more than $5,050 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 $3,350 in the case of individual coverage and no more than $6,150 in the case of family coverage.[136] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Taxation of distributions

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.[137] However, in any year for which a contribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[138] For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

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

Cap on taxpayers utilizing Archer MSAs

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the pilot period 1997-2003, only those individuals who (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer

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[136] These dollar amounts are for 2003. These amounts are indexed for inflation in $50 increments.

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

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

MSA participants) or (2) are employed by a participating employer are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.[139] However, if the threshold level is exceeded in a year, previously uninsured individuals would be subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

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

Duration of Archer MSA pilot program

Without extension, after 2003, no new contributions could be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made Archer MSA contributions of at least $100 in a taxable year ending in 2003. Self-employed individuals who made contributions to an Archer MSA during the period 1997-2003 also would have been able to continue to make contributions after 2003.

Description of Proposal

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

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

The proposal also allows contributions to an Archer MSA, by both employers and employees, up to 100 percent of the maximum deductible under the plan, up to the applicable limit for the individual for the year. Under the proposal, contributions to Archer MSAs can be made through a cafeteria plan.

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

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

Analysis

In general

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

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

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

Complexity issues

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

Prior Action

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

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

Present Law

In order to determine taxable income, an individual reduces adjusted gross income by a dollar amount ($3,050 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, 2003.

Analysis

Complexity issues

The addition of a new personal exemption with special criteria, while beneficial to taxpayers, 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

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

7. 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. 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. Depending upon when the drug is designated as a potential treatment for a rare disease or disorder, the taxpayer could claim the credit for pre-designation costs either in the year of designation or by filing an amended return for expenses related to prior taxable years.

Effective date.–The provision is effective for expenditures paid or incurred after December 31, 2002.

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.

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. The proposal would reduce complexity by treating all human clinical trial expenses in the same manner for purposes of the credit and any allowable deduction.

The staff of the Joint Committee on Taxation recommended this change as part of its 2001 simplification study.[140]

Prior Action

No prior action.

[140] 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.

D. 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, 2003.

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 and 2003 budget proposals.

E. 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 based initially on the 2000 census data. 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 $1.75 of tax credit authority annually to each State for every resident in the State beginning in calendar year 2004. The $1.75 amount is indexed for inflation beginning in calendar year 2004. 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. Also, 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 the value of the credits allocated to the housing unit being resold, reduced by 1/36th of that value for each month between the initial sale and the sale to the nonqualified buyer. If a housing unit for which any credit was claimed is converted to rental property within the initial five-year period then no deductions for depreciation or property taxes can be claimed with respect to such unit for the balance of that five-year period. The proposal does not provide how the qualified homebuyer (or subsequent buyer) will know what the recapture amount for their housing unit.

Effective date.–The proposal is effective beginning in calendar year 2004.

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[141] the developer/seller may claim under the proposal. Alternatively, there may be no change in purchase price (compared to an otherwise comparable

[141] 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.[142] For example, if there are relatively few properties of a comparable type and it is difficult to obtain land or building permits to build more such properties, the more likely it will be that qualifying homebuyers bid against one another for a property. By bidding up the sales price of the property, more of the economic benefit of the tax credit accrues to the seller. Oppositely, if there are relatively few qualified buyers, but there are several potential developers who have credit allocations and can easily supply housing for sale, the developers may compete against each other to sell to a qualifying buyer by lowering the price they charge to such buyers. By lowering the price of the property under competitive pressure, more of the economic benefit of the tax credit accrues to the buyer.

Because of the diversity in market conditions of different local housing markets, it is not possible to predict whether buyers or sellers are likely to be the primary economic beneficiary of the proposed tax credit. The proposal requires that the credit may only be claimed for sales that occur within one year of the property being certified for occupancy. The time limit may exert pressure on developers to reduce the price of the property in order to sell it before the one-year period expires. On the other hand, the limit on the number of properties on which the credit may be claimed may impose a supply constraint. Potential qualifying buyers 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

[142] 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.[143] 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[144] 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.

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

[144] 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

An substantially similar proposal was included in the President’s fiscal year 2002 and 2003 budget proposals.

F. 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.[145] The qualified entity chooses a matching rate, which must be between 50 and 400 percent. Withdrawals from individual development account can be made for certain higher education expenses, a first home purchase, or small business capitalization expenses. Matching contributions (and earnings thereon) typically are held separately from the individuals' contributions (and earnings thereon) and must be paid directly to a mortgage provider, university, or business capitalization account at a financial institution. The Department of Health and Human Services administers the individual development account program.

Description of Proposal

The proposal provides for a nonrefundable tax credit for an eligible entity (i.e., qualified financial institutions, qualified nonprofits organizations and qualified Indian tribes) that has an individual development account program in a taxable year. The tax credit equals the amount of matching contributions made by the eligible entity under the program per account (up to $500 per taxable year) plus $50 for each individual development account maintained during the taxable year under the program. Except in the first year that each account is open, the $50 credit 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 2003. 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) that 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.[146] Eligibility in a

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

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

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 2003. 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.

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 as well as nonqualified expenses subject to certain restrictions. Qualified expenses include qualified: (1) higher education expenses (as generally defined in section 529(e)(3)**;** (2) first-time homebuyer costs (as generally provided in section 72 (t)(8); (3) business capitalization or expansion costs (expenditures made pursuant to a business plan that has been approved by the financial institution, nonprofit, or Indian tribe); (4) rollovers of the balance of the account (including the parallel account) to another individual development account for the benefit of the same owner; and (5) final distributions in the case of a deceased account owner. Withdrawals for qualified expenses must be paid directly to the unrelated third party to whom the amount is due, except in the case of expenses under a qualified business plan, rollover, or final distribution. Such withdrawals generally are not permitted until the account owner completes a financial education course offered by a qualified financial institution, qualified nonprofit organization, Indian tribe or governmental entity. The Secretary of the Treasury (the "Secretary") 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 2002. Matching funds may be provided also by State, local, or private sources. Balances of the individual development account and parallel account is 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 accounts 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

Complexity issues

In general, adding this 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.

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 unfair tax treatment of similarly situated individuals, and may effectively allow financial and other eligible institutions to pick and choose the recipients of tax benefits. Additionally, individuals without ready access to eligible institutions are disadvantaged with respect to receiving a tax benefit for saving under the proposal.

Prior Action

A substantially similar proposal was included in the President's fiscal years 2002 and 2003 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.*[147] 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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[147] *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.[148] 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

[148] 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, and fiscal year 2003 budget proposals.

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

Present Law

Income tax treatment of dispositions of land

Capital gains treatment

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

Land is a capital asset, unless it is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or it is used in the taxpayer's trade or business. In addition, if the gains from property, including land, used in a taxpayer's trade or business 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 or loss is deferred if land is condemned and replaced with other property of a like kind (sec. 1033(g)).

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

Charitable contributions generally

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

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

<u>Capital gain property</u>

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.

<u>Qualified conservation contributions</u>

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 Code 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,[149] 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, 2004.

Analysis

Policy issues

In general, for sales of real estate, the maximum tax rate applied to capital gain income (excluding improvements) is 20 percent for taxpayers who would otherwise be in the 27 percent, 30 percent, 35 percent, and 38.6 percent ordinary income tax brackets.[150] If such a taxpayer sold conservation property to a qualifying conservation organization, after the 50-percent exclusion, the effective tax rate on the gain income would be 10 percent.[151] Per $1,000 of gain, the proposal could produce a benefit of up to $100 if the taxpayer were to sell to a qualifying conservation organization rather than to another person offering the same purchase price.[152] 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 their purchase of property can qualify a taxpayer for a lower effective tax rate (a higher after-tax

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

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

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

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

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 10 percent of the purchase price of the property.[153]

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.

Complexity issues

In its report,[154] the staff of the Joint Committee on Taxation identified the taxation of income from capital gains as an area of complexity in the individual income tax. The staff of the Joint Committee on Taxation has identified nine different categories of capital gain, often with multiple rates of tax applying within each category depending upon the taxpayer's circumstance. Present law requires a holding period of one year or more and five years or more for a taxpayer to avail him or herself of the benefit of the alternative tax rates applicable to capital gain income. The proposal layers an exclusion for the sale of certain assets on top of the present law alternative rate schedule. The proposal would create a new three-year holding period

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[153] 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 or in the case of property held for five years or longer, the comparable percentages would be lower.

[154] 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.

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 has held the property for five years or more and thus whether the seller's effective rate of tax may be nine percent rather than 10 percent. As accurate estimates might be crucial to submitting a winning offer for qualifying property, the qualifying conservation organization, in principle, would need to have information about the financial affairs of the seller. Such an offer strategy is a more information intensive process than typical real estate transactions.

The proposal 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. In practice, the proposal also may require that a purchasing qualifying conservation organization offer a seller some sort of indemnification to protect the seller from adverse tax consequences that might result from a subsequent transfer or use of the property that would not satisfy the conservation restrictions of the proposal.

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. The prior budget proposals did not include penalty and bargain-sale provisions.

A similar proposal is included in section 107 of S. 256, the "CARE Act of 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

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 2002. 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).

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, 2005. 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 or 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 is derived from:

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

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

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

Qualifying open-loop facilities are any facility placed in service before January 1, 2005. In the case of facilities placed in service before January 1, 2003, taxpayers are eligible for credit for production from newly eligible sources from January 1, 2003 through December 31, 2005 (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 or closed-loop biomass co-fired with coal, qualifying facilities are any facility placed in service before January 1, 2005. Taxpayers producing electricity from such facilities will only be eligible to claim credit for electricity produced from newly eligible sources from January 1, 2003 though December 31, 2005 (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 or closed-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 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.

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

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 would have added eight new types of qualifying facilities.

2. Tax credit for residential solar energy systems

Present Law

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

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

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

There is no present-law personal tax credit for residential solar energy property.

Description of Proposal

The proposal provides a tax credit for the purchase of rooftop photovoltaic systems and solar water heating systems for use in a dwelling unit that is used by the taxpayer as a residence.

Equipment qualifies 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. For businesses, this credit is subject to the limitations of the general business credit and the basis of the qualified property is reduced by the amount of the credit claimed. Taxpayers must choose between the proposed credit and the present tax credit for each investment.

Effective date.–The credit applies to equipment placed in service after December 31, 2002 and before January 1, 2006 for solar water heating systems and after December 31, 2002 and before January 1, 2008 for rooftop photovoltaic systems.

Analysis

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

Prior Action

Substantially similar proposals were contained in the President's Fiscal Year 1999 through 2003 Budget Proposals. Similar provisions are contained in Division C of H.R. 4, "The Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and 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. 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.[155]

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

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

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[157] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[158]

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

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[155] 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.

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

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

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

qualified fund rules.[159] 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.

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

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

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, 2002.

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.[160] 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

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

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 2003 budget proposal. A similar provision was included in Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001. The cost of service provision and the clarifications of the treatment of transfers and deductibility of decommissioning costs were included in Division H of the Senate Amendment to H.R. 4, the "Energy Tax Incentives Act of 2002," as passed by the Senate on April 25, 2002.

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

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2007. The credit phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006. There is no carry forward or carry back of the credit for electric vehicles.

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction for clean-fuel vehicles phases down in the years 2004 through 2006, and is unavailable for purchases after December 31, 2006.

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, 2002 and before January 1, 2008. 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 8, below, shows the proposed base credit amounts.

Table 8.–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

	If Rechargeable Energy Storages System Provides:	
Base Credit Amount	**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 9, 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 9.–Additional Fuel Economy Credit for Hybrid Vehicles

	If Fuel Economy of the Hybrid Vehicle Is:	
Credit	**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 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 10, below, shows the proposed credits for qualifying fuel cell vehicles.

Table 10.–Credit for Qualifying Fuel Cell Vehicles

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

Base fuel economy

The base fuel economy 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 11, below, shows the 2000 model year city fuel economy for vehicles by type and by inertia weight class.

Table 11.–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

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
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, 2002.

Analysis

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

Prior Action

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

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

Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, would extend section 179A, would extend and modify section 30, and would provide new credits for the purchase of alternative fuel vehicles, hybrid vehicles, fuel cell motor vehicles, and advanced lean burn technology vehicles. Division H of H.R. 4, the "Energy Tax Incentives Act of 2002," as amended by the Senate on April 25, 2002, would extend section 179A, would extend and modify section 30, and would provide new credits for the purchase of alternative fuel vehicles, hybrid vehicles, and fuel cell motor vehicles, and would provide a credit for the cost of installing clean-fuel vehicle refueling property.

5. Provide tax credit for energy produced from landfill gas

Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (section 29). For the year 2001, the inflation adjusted value of the credit was \$6.28 per barrel or oil or barrel equivalent (*e.g.*, \$1.11 per thousand cubic feet of natural gas[161]). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

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

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

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

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

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

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, 2002 and before January 1, 2011, and is sold (or used to make electricity) before January 1, 2011. In the case of a landfill that was placed in service before January 1, 2003, the proposal provides that the term "facility" included the wells, pipes, and related components used to collect landfill methane and that production of gas attributable to wells, pipes, and related components placed in service after December 31, 2002 is treated as produced from the portion of the facility placed in service after that date.

In the case of gas produced at landfills subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines, the taxpayer 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, 2003 in all other cases.

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

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[161] 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.

Analysis

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

Prior Action

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

The President's fiscal year 2001 and 2002 budgets proposed adding landfill gas to the electricity production credit under section 45. The President's fiscal year 2003 budget proposed a similar proposal to the current proposal (identical except for certain placed in service dates and fuel production dates).

Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, would permit landfill gas from facilities placed in service after June 30, 1998 and before January 1, 2007 to claim credit for production for five years at a credit rate of $3.00 (indexed) per barrel equivalent ($2.00 in 2002 in the case of gas from a landfill subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines). Division H of H.R. 4, the "Energy Tax Incentives Act of 2002," as amended by the Senate on April 25, 2002, would reduce the credit rate to $3.00 per barrel of oil equivalent for wells placed in service after the date of enactment and before January 1, 2005. In addition, the Senate amendment would have expanded the list of qualifying fuels.

6. 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 provides a 10 percent credit for the purchase of combined heat and power property.

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

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

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

Effective date.–The credit applies to equipment placed in service after December 31, 2002 and before January 1, 2008.

Analysis

See General discussion immediately below.

Prior Action

A similar proposal was contained in the President's Fiscal Year 2000 and 2003 Budget Proposals. Similar provisions are contained in Division C of H.R. 4, the "Energy Tax Policy Act of 2001," as passed by the House of Representatives on August 2, 2001, and 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. - 5.

General rationale for tax benefits for energy conservation and pollution abatement

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

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

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

Targeted investment tax credits

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

As a general matter of economic efficiency, tax credits designed to influence investment choices should be used only when it is acknowledged that market-based pricing signals have led to a lower level of investment in a good than would be socially optimal. In general, this can occur in a market-based economy when private investors do not capture the full value of an investment--that is, when there are positive externalities to the investment that accrue to third parties who did not bear any of the costs of the investments. For example, if an individual or corporation can borrow funds at 10 percent and make an investment that will return 15 percent, they will generally make that investment. However, if the return were 15 percent, but only 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.[162] 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.

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[162] 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.

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 or to limit revenue losses, but again, this conflicts with the goal of pollution reduction.

A justification for targeted tax credits that has been offered with respect to some pollution abatement activities, such as home improvements that would produce energy savings (installation of energy saving light bulbs or attic insulation, for example), is that the investment is economically sound at unsubsidized prices, but that homeowners or business owners are unaware of the high returns to the investments. The argument for targeted tax credits in this case is that they are needed to raise the awareness of the homeowner, or to lower the price sufficiently to convince the homeowner that the investment is worthwhile, even though the investment is in their interest even without the subsidy. These arguments have been called into question recently on the grounds that the returns to the investments have been overstated by manufacturers, or are achievable only under ideal circumstances. This view holds that the returns to these investments are not dissimilar to other investments of similar risk profile, and that homeowners have not been economically irrational in their reluctance 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.[163] 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

[163] 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.

similar magnitude, or if administrative considerations would make multiple credit rates problematic.

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

Complexity issues

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

In general, the production tax credits add less complexity in the aggregate as there are relatively few taxpayers in a position to claim such benefits. The personal credits, such as those for solar equipment and hybrid vehicles, add more aggregate complexity as many more taxpayers will avail themselves of the credit and they could induce millions more to at least consider purchasing hybrid vehicles or solar equipment as a result of the credit.

7. Extend income tax credit and partial excise tax exemption for certain renewable fuels

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

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:[164]

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

[164] 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.

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. The amount of the credit/rate reductions are reduced as scheduled under present law. Also, as under present law, no credit or rate reduction is available during any period when the Highway Trust Fund fuel excise taxes are limited to 4.3 cents per gallon or less.

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 averaged approximately $1.40 per gallon in 2001 in the United States. The present-law tax subsidy is 38 percent of the market price. Proponents of such subsidies for ethanol state that the present-law tax credit helps advance several policy goals. As a motor fuel, ethanol displaces petroleum in the market place. To the extent that the petroleum displaced is imported, 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.[165] Opponents also note increased regulatory preference for ethanol as an oxygenate to meet air quality standards. They observe that such air quality regulations should produce increased demand for ethanol in the market and question whether further subsidy at current levels is warranted if other forces are creating an increase in demand.

Complexity issues

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

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.

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

III. TAX ADMINISTRATION PROVISIONS

A. IRS Restructuring and Reform Act of 1998

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

Present Law

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

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

Description of Proposal

The proposal 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.[166] 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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[166] 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 budget proposal.[167]

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[168] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

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[167] The original provisions were enacted in the IRS Restructuring and Reform Act of 1998.

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

Description of Proposal

The proposal 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.[169] 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 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.

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[169] 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)).

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.[170]

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.[171]

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.

Effective date.–The proposal is effective for installment agreements entered into on or after the date of enactment.

[170] The fiscal year 2003 budget proposal also applied to taxpayer assistance orders.

[171] Sec. 6331(k).

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.

The proposal states that, if the taxpayer's financial circumstances improve, the IRS could collect a larger amount, including the full amount due.[172] It is not clear whether this would happen more than infrequently. 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[173] 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.[174] 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

[172] This is permitted under present law. Sec. 6159(b)(3).

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

[174] Sec. 7122.

applicable to offers in compromise, taxpayers may prefer to apply for a partial payment installment agreement to achieve the same effect: a reduction in the total amount of tax they will have to pay.

The proposal 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.[175] Although it might be possible to apply this automatic installment agreement provision to partial payment installment agreements, the more appropriate policy result might be to restrict automatic installment agreements to those where the liability is to be paid in full. The proposal also does not specify how it interacts with the related proposal permitting termination of installment agreements if the taxpayer fails to file tax returns or make required deposits. The more appropriate policy result might be to terminate a partial payment installment agreement in the same circumstances under which any other installment agreement is terminated.

Complexity issues

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

Prior Action

An identical proposal was included in the President's fiscal year 2003 budget proposal.

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.

[175] Sec. 6159(c).

Under present law, the IRS is permitted to terminate an installment agreement only[176] 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.[177]

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[178] 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 instating liens and levies, which could increase government receipts. In the past

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

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

[178] 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).

several years, however, there has been a significant decline in IRS' enforced collection activities, so that others might respond that terminating installment agreements might not lead to increased receipts to the government, in that the cessation of receipts due to termination of installment agreements may outweigh increases in receipts through additional enforcement activities.

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 budget proposal.

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[179] and is a court of limited jurisdiction.[180]

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 suits to obtain judicial review filed 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 process cases. The judicial appeals structure of present law was designed in recognition of these

[179] Sec. 7441.

[180] Sec. 7442.

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.[181]

Some believe that present law "entitles a taxpayer patently seeking delay to achieve his goal by refiling in the District Court."[182] The proposal would provide simplification benefits by eliminating this opportunity for delay.

Prior Action

An identical proposal was included in the President's fiscal year 2003 budget proposal. 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.[183]

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

Present Law

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

Description of Proposal

The proposal 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. Written opinions would only be provided if the Secretary determines that an opinion is required with respect to a compromise.

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[181] 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.

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

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

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.[184]

Prior Action

An identical proposal was included in the President's fiscal year 2003 budget proposal.

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

B. 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, 2002; these returns will be filed in 2004.

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[185] for paying the balance due[186] with the return: (1) credit card; or (2) electronic funds withdrawal.[187] Credit card

[185] 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.

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

providers charge a convenience fee[188] in addition to the amount of tax due, which may deter some individuals from paying the balance due electronically.

Although the proposal may in many instances reduce administrative burdens, having two different filing deadlines could be considered to increase complexity. It would, for example, require explaining two filing deadlines, which is likely to be more complex than explaining one. Another factor that could affect complexity is 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.[189] 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

Substantially similar proposal was included in the President's fiscal year 2003 budget proposal.

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[187] 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.

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

[189] *See* IRS Publication 1345A, Filing Season Supplement for Authorized IRS e-file Providers, pp. 17-8 (November 26, 2002).

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 income 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.

Nonqualified deferred compensation is generally subject to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

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.[190] 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.

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[190] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

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 individuals' 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.

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.[191] 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.[192] 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.[193] 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.[194] 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

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[191] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

[192] The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60-31, 1960-1 C.B. 174.

[193] Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 69-49, 1969-1 C.B. 138.

[194] 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.

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.[195]

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978[196] 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.

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.

[195] Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

[196] Pub. L. No. 95-600 (1978).

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 may have 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.[197] 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.

[197] *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

No prior action.

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[198] 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 recently revised its extensive Request for Information concerning its possible use of private debt collection companies.[199]

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.[200] That provision does not apply to the collection of debts under the Internal Revenue Code.[201] 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.[202] If the taxpayer's last known address is incorrect, the private debt collection

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[198] GAO/GGD-97-129R Issues Affecting IRS' Collection Pilot (July 18, 1997).

[199] 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.

[200] 31 U.S.C. 3718.

[201] 31 U.S.C. 3718(f).

[202] 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.[203] 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.[204] 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.[205] Second, taxpayer protections that are statutorily applicable to the IRS would also be made statutorily applicable to the private sector debt collection companies.[206] Third, the private sector debt collection companies would be required to inform taxpayers of the availability of assistance from the Taxpayer Advocate.

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. Their compensation would be "based upon a number of factors, including quality of service, taxpayer satisfaction, and case resolution, in addition to collection results."[207]

<u>Effective date</u>.–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.

[203] 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.

[204] Although the proposal does not explicitly say so, presumably taxpayers could choose an installment agreement of less than three years.

[205] This is present law.

[206] 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).

[207] Treasury General Explanations, p. 99.

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,[208] owed by over 6.1 million individuals and businesses.[209] 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

No prior action.

[208] This is the dollar value of what the IRS calls the "Potentially Collectible Inventory;" it excludes amounts deemed to be uncollectible or duplicative assessments.

[209] TIRNO-03-H-0001 (February 14, 2003), at www.procurement.irs.treas.gov. Attachment #3.

E. 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.[210] 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.[211]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[212] a transaction that the IRS has identified to be a tax avoidance transaction (a "listed transaction").[213]

The second category is any "confidential transaction." A "confidential transaction" is a transaction that is offered under conditions of confidentiality. If a taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited in any manner by an express or implied understanding or agreement with (or for the benefit of) any person who makes or provides a statement (oral or written) as to the potential tax consequences that may result from the transaction (whether or not legally binding), it is considered offered under conditions of confidentiality.[214]

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[210] On February 27, 2003, Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. The discussion of present law refers to the final regulations.

[211] 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. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the availability of defenses to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

[212] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

[213] Treas. Reg. sec. 1.6011-4(b)(2).

[214] Treas. Reg. sec. 1.6011-4(b)(3).

The third category of reportable transaction is any transaction for which the taxpayer has obtained or been provided with contractual protection. A transaction has contractual protection if the taxpayer has the right to a full or partial refund of fees if part or all of the intended tax consequences from the transaction are not sustained.[215]

The fourth category of reportable transactions relates to any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss 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 for all other partnerships; (3) $2 million in any single year or $4 million in any combination of years by an individual, S corporation, or trust; or (4) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[216]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[217] 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.[218]

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.[219]

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.

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[215] Treas. Reg. sec. 1.6011-4(b)(4).

[216] Treas. Reg. sec. 1.6011-4(b)(5). In connection with the loss transaction category, the IRS issued Revenue Procedure 2003-24, which excludes certain types of losses from the reportable transaction rules.

[217] 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. Treas. Reg. sec. 1.6011-4(b)(6)(ii)(A).

[218] Treas. Reg. sec. 1.6011-4(b)(6). In connection with the significant book-tax category, the IRS issued Revenue Procedure 2003-25, which excludes 30 types of book-tax differences from the reportable transaction rules.

[219] Treas. Reg. sec. 1.6011-4(b)(7).

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.[220] A "tax shelter" means any investment with respect to which the tax shelter ratio[221] 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 securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[222]

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

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[220] Sec. 6111(a).

[221] 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.

[222] Sec. 6111(c).

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.[223]

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,"[224] 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.[225] Certain exceptions are provided with respect to the second category of transactions.[226]

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.[227]

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.[228] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the 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.

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[223] Sec. 6111(d).

[224] Treas. Reg. sec. 301.6111-2(b)(2).

[225] Treas. Reg. sec. 301.6111-2(b)(3).

[226] Treas. Reg. sec. 301.6111-2(b)(4).

[227] 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 are 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).

[228] Sec. 6707.

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 provision also will be modified 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).[229] Recently finalized regulations under section 6112 provide rules regarding the list maintenance requirements.[230]

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) any transaction that 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).[231]

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[229] Sec. 6112.

[230] Treas. Reg. sec. 301.6112-1.

[231] Treas. Reg. sec. 301.6112-1(b).

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.[232] A "material advisor" is defined 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.[233] 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.[234]

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[235] is required to maintain a list that (1) identifies each person with respect to whom 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

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[232] Treas. Reg. sec. 301.6112-1(c)(1).

[233] Treas. Reg. sec. 301.6112-1(c)(1) and (2).

[234] Sec. 6112(c)(2).

[235] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

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.[236]

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.[237]

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[238] and the keeping of lists of investors by material advisors.[239] 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 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 person makes a transaction or maintains an account with a foreign financial entity.[240] 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 Department of the Treasury, and not as part of the tax return that is filed with the IRS.

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[236] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

[237] Sec. 7408.

[238] Sec. 6707, as amended by other proposals of this package.

[239] Sec. 6708, as amended by other proposals of this package.

[240] 31 U.S.C. 5314.

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.[241] 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.[242]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[243] This report, which was statutorily required,[244] 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.

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. 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.

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[241] 31 U.S.C. 5321(a)(5).

[242] 31 U.S.C. 5322.

[243] *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.

[244] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

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.

Effective date.–The proposal generally is effective after the date of enactment.

7. Holding period requirement for obtaining foreign tax credit

Present Law

In general, U.S. persons may credit foreign taxes against U.S. income tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. income tax on U.S.-source income. Separate limitations are applied to specific categories of income.

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. income tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") 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 or a RIC 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.

Effective date.–The proposal generally is effective after the date of enactment.

8. 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.[245]

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).[246] However, there are no specific statutory rules that address income stripping transactions with respect to common stock or other equity interests (other than preferred stock).[247]

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[245] *Helvering v. Horst*, 311 U.S. 112 (1940).

[246] 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).

[247] 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.

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[248] 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.[249] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of 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.[250] 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 of either the stripped bond or one or more stripped coupons must allocate basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[251] 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 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

[248] Sec. 1286.

[249] Sec. 1286(e).

[250] Sec. 1286(a).

[251] 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.

items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[252]

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.[253] 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.[254] 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.[255]

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

Complexity issues

The proposals regarding increased disclosure of tax avoidance transaction 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 will mean 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, and amount of disclosure requested by the Treasury Department is not burdensome.

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[252] 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)).

[253] Sec. 305(e)(5).

[254] Sec. 305(e)(1).

[255] Sec. 305(e)(3).

The substantive proposals regarding foreign tax credit holding period requirements 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.

Policy issues

Individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax. Such a phenomenon could pose 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.[256] The Administration's Fiscal Year 2004 Revenue Proposals to combat abusive tax avoidance transactions (the "Treasury shelter proposals") are the proposals that were contained in the Treasury shelter initiative.

The Treasury shelter 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 whose effectiveness depends heavily on increased disclosure.

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 both cases, it may

[256] *See generally*, "*The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions*," released on March 20, 2002, *reprinted electronically at* 2002 TNT 55-28 (March 21, 2002).

be difficult to develop specific operative rules that appropriately distinguish between legitimate transactions and abusive transactions.

Prior Action

As previously noted, the Treasury shelter proposals were contained in a Treasury shelter initiative released in March 2002. During 2002 and 2003, a number of legislative proposals have included various aspects of the Treasury shelter proposals.[257]

[257] *See*, e.g., Senate Finance Committee Report of S. 476, *CARE Act of 2003*, (S. Rep. No. 108-11, February 27, 2003); H.R. 5095, the American Competitiveness Act of 2002.

F. Limit Related-Party Interest Deductions

Present Law

Present law limits the ability of U.S. corporations (among other taxpayers) to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[258] if: (1) the payor's debt-to-equity ratio exceeds 1.5 to 1 (the so-called "safe harbor"); and (2) 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).

Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

Description of Proposal

In general

The proposal changes present law by: (1) modifying the safe harbor provision; (2) reducing the adjusted taxable income threshold; (3) adding a new disallowance provision based on a comparison of domestic to worldwide indebtedness; and (4) limiting carryovers.

Modified safe harbor

The proposal replaces the present-law debt-to-equity safe harbor with a safe harbor based on a series of debt-to-assets ratios. Under the proposal, a safe-harbor debt amount for an interest-paying U.S. corporation is computed by: (1) categorizing all of the corporation's assets into specified classes; (2) multiplying the asset value in each class by a stated debt-to-assets ratio for such class; and (3) summing such amounts.[259] A corporation would face interest disallowance under section 163(j) only if its debt exceeded this safe harbor amount.

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[258] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

[259] Equity investments in foreign related parties (other than investments in subsidiaries) are not taken into account. For example, if a U.S. subsidiary of a foreign parent corporation owned some stock of the foreign parent, this stock would be disregarded for purposes of determining the U.S. subsidiary's safe-harbor amount.

The asset classes and corresponding ratios are set forth in the following table:

Asset class	Debt-to-assets ratio
Cash, cash equivalents, government securities	.98
Municipal bonds, publicly traded debt securities, receivables	.95
Publicly traded equities, mortgages and other real estate loans, other corporate debt and third-party loans	.90
Trade receivables and other current assets	.85
Inventory	.80
Land, depreciable assets, other investments, loans to shareholders	.70
Intangible assets	.50

<u>Reduced adjusted taxable income threshold</u>

The proposal reduces the present-law threshold of 50 percent of adjusted taxable income to 35 percent. Thus, under the proposal, if a taxpayer's debt exceeds the safe-harbor amount, then disqualified interest may be disallowed to the extent that it exceeds 35 percent of adjusted taxable income.

<u>Domestic-foreign indebtedness comparison</u>

The proposal also adds a new interest disallowance rule, which disallows related-party interest to the extent that a U.S. subsidiary of a foreign parent is more highly leveraged than the overall worldwide corporate group. For purposes of applying this new test, financial corporations are treated as a separate sub-group. The amount of interest disallowed under this rule is the amount of interest attributable to the excess U.S. indebtedness, determined by a comparison of U.S. to worldwide debt-to-assets ratios. For purposes of this rule, excess U.S. indebtedness cannot exceed the amount (if any) by which a corporation's U.S. indebtedness exceeds its safe-harbor debt amount. Thus, this rule applies only to corporations that exceed the safe harbor, and only to interest attributable to such excess.

The modified present-law disallowance rule and the new disallowance rule are coordinated by providing that the rule yielding the greater amount of interest disallowed determines the overall disallowance.

<u>Carryovers</u>

The proposal limits the carryforward of interest disallowed under the "adjusted taxable income" limitation to five years. The proposal allows no carryover of interest disallowed under the domestic-foreign indebtedness test. The proposal eliminates the carryover of excess limitation.

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

Analysis

Policy issues

In analyzing the earnings stripping proposal, it is useful to review some relevant background. In the course of recent public discussion and legislative activity regarding corporate "inversion" transactions, it became apparent that inversion transactions generally were entered into with a view to obtaining either or both of the following U.S. tax benefits: (1) removing some or all of the inverting corporate group's foreign operations and income from the U.S. taxing jurisdiction, thereby potentially achieving pure territorial tax treatment for the group with respect to the United States; and (2) reducing the U.S. taxes that otherwise would be incurred on income from U.S. operations, through the use of various earnings stripping strategies (e.g., making excessive payments of deductible interest or royalties to a new foreign parent). In some cases, it appeared that this latter earnings stripping benefit constituted the primary intended tax benefit of the transaction.[260] This provided some evidence that the earnings stripping rules were not fully achieving their intended purposes and led some to conclude that these rules needed to be strengthened.[261]

The Department of the Treasury describes the proposal as both strengthening the earnings stripping rules and tailoring them more appropriately to different taxpayers' businesses.[262] The proposal's modifications to the safe harbor perform this tailoring function, by gearing a corporation's safe-harbor debt amount to the value and nature of the assets supporting its debt, instead of applying a single debt-equity threshold to all corporations irrespective of asset mix, as present law does.

In view of the specific debt-to-assets thresholds employed in this modified safe harbor, the extent to which the proposal ultimately strengthens the earnings stripping rules is unclear. Converting the proposed debt-to-assets thresholds into debt-to-equity thresholds, it appears that in many cases the proposal may provide a more generous safe harbor than does the present-law debt-to-equity threshold of 1.5:1. For example, the proposed .98 debt-to-asset ratio for cash equivalents may be compared to a debt-to-equity ratio of 49:1, the proposed .80 ratio for

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[260] *See, e.g.*, Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, May 17, 2002, Part VII.A ("Treasury study"); 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.

[261] *See, e.g.*, Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 2003, 104 ("Treasury explanation") ("Under current law, opportunities are 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."); Treasury study, Part VII.A. ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited").

[262] Treasury explanation, at 104.

inventory may be compared to a debt-to-equity ratio of 4:1, and the proposed .70 ratio for land and depreciable assets may be compared to a debt-to-equity ratio of 2.33:1. Only in the case of intangible assets does this comparison indicate a tightening of the safe harbor beyond present law, as the proposed ratio of .50 may be compared to a debt-to-equity ratio of 1:1. Thus, it appears that companies with an asset mix weighted toward intangible assets face a tighter safe harbor under the proposal, but that other companies may benefit from a widening of the safe harbor.[263]

As to those companies that fall outside the safe-harbor, the proposal further limits the opportunities for earnings stripping, by reducing the adjusted taxable income threshold from 50 percent to 35 percent, adding the domestic-foreign indebtedness comparison, and further limiting carryovers. These provisions of the proposal are similar to the earnings stripping provision of H.R. 5095, a bill introduced in July 2002 by Mr. Thomas, Chairman of the House Committee on Ways and Means.[264]

Complexity issues

The proposal would add significant complexity to the Code. Categorizing and measuring assets for purposes of the modified safe harbor would likely be difficult for taxpayers. In addition, the domestic-foreign indebtedness comparison, which requires detailed tracking of foreign assets and debt, would be burdensome and difficult to apply.

Prior Action

Similar changes to the earnings stripping rules were discussed in the Treasury study of May 2002,[265] and were included H.R. 5095. The proposal in H.R. 5095 did not include the present proposal's asset-specific modifications to the safe-harbor provisions, among other differences.

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[263] It should be noted, however, that by excluding equity investments in foreign related parties (other than subsidiaries), the proposal addresses one of the ways in which certain earnings stripping structures may be most easily implemented (through the use of so-called "hook stock").

[264] *See* H.R. 5095, 107th Cong., 2d Sess., July 11, 2002, sec. 201; *see also* Joint Committee on Taxation, *Technical Explanation of H.R. 5095 (the "American Competitiveness Act of 2002")* (JCX-78-02), July 19, 2002, 42-43.

[265] *See* Treasury study, Part VII.A.

IV. UNEMPLOYMENT INSURANCE

A. Reform Unemployment Compensation

Present Law

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

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

Description of Proposal

The proposal repeals the temporary FUTA surtax in 2005. It further reduces the gross FUTA tax rate to 5.6 percent in 2009.

Apart from tax provisions, the responsibility for the program's administrative funding is transferred solely to the States in 2006 as part of a comprehensive reform of the unemployment compensation program. During the transition to greater State financing, larger administrative grants and special Reed Act distributions will be provided to the States ($2.7 billion in Reed Act Funds on October 1, 2006 and October 1, 2007).

Effective date.–The provision generally would be effective for labor performed on or after January 1, 2004.

Analysis

Complexity issues

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

Policy issues

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

Prior Action

A substantially similar proposal was included in the President's fiscal year 2003 budget proposal.

V. SIMPLIFY THE TAX LAWS

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[266]

In general

Taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. For 2003, the amount deductible for each personal exemption is $3,050. The deduction for personal exemptions is phased out for taxpayers with incomes above certain thresholds.[267]

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;[268] and (5) did not file a joint return with his or her spouse for the year.[269] In addition, the taxpayer identification number of the individual must be included on the taxpayer's return.

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[266] 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.

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

[268] 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.[270] 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.[271] 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.[272] 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).

[269] 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.

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

[271] *Id.*

[272] *Id.*

There was no intent on the part of the taxpayer or the woman to change her principal place of abode.[273]

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.[274] 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.[275] 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.[276]

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

[274] 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 purpose of the support test. Sec. 152(d).

[275] 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).

[276] 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.[277] 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.[278] 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[279]

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;[280] (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 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.[281]

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[277] 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).

[278] Sec. 151(c).

[279] Sec. 32.

[280] 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).

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

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.[282] 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.[283] 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. 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[284]

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 $600, in the case of taxable years beginning in 2003 or 2004. The child credit increases to $700 for taxable years beginning in 2005 through 2008, $800 for taxable years beginning in 2009, and $1,000 for taxable years beginning in 2010.[285] The credit declines to $500 in taxable year 2011.[286] 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

[282] 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).

[283] IRS Publication 596, *Earned Income Credit (EIC)*, at 13. H. Rep. 101-964 (October 27, 1990), at 1037.

[284] Sec. 24.

[285] A separate proposal contained in the President's fiscal year 2004 budget proposal accelerates the increase in the child credit and makes the credit amount $1,000 after 2010.

[286] 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).

calendar year. In addition, the child must be a citizen or resident of the United States.[287] A portion of the child credit is refundable under certain circumstances.[288]

<u>Dependent care credit</u>[289]

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, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself,[290] 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.[291] 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.

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[287] 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).

[288] Sec. 24(d).

[289] Sec. 21.

[290] 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.

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

Head of household filing status[292]

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.[293] 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.

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.

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.

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[292] Sec. 2(b).

[293] 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.

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.

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. 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.

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).

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.

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.

The proposal retains 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, 2003.

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.[294] 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 20 pages,[295] comprised of the following:

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[294] *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.

[295] The page number total has increased from 17 pages since the Joint Committee on Taxation simplification study was released in April 2001, with the increase attributable to expanded instructions regarding the dependent care credit and head of household filing status.

- 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;[296]
- Earned income credit: three pages, including a chart illustrating the definition of qualifying child;[297]
- Child credit: part of one page;[298]
- Dependent care credit: four 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;[299]
- Head of household filing status: three pages, including a chart illustrating the requirements for head of household filing status.[300]

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.[301]

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.[302] As another

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[296] IRS Publication 17, *Your Federal Income Tax (for Individuals)*, 26-34.

[297] *Id.* at 248-251.

[298] *Id.* at 235.

[299] *Id.* at 217-220.

[300] *Id.* at 23-25.

[301] IRS Publication 596, *Earned Income Credit (EIC)*, 10-16.

[302] 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

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.[303] 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."[304] 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.[305] 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.

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 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).

[303] 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.

[304] *Id.*

[305] 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.

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 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, [306] and taxpayers may not know whether they have provided over one half the support of another individual.[307] 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,

[306] 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.

[307] 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.

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.

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.[308] 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. The staff of the Joint Committee on Taxation recommended elimination of the "care for" requirement with respect to the uniform definition of 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.

[308] 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.

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 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. 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 dependent care credit shifting from the provider of support (under present law) to the taxpayer who satisfies the residency test (under the proposal).[309] 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 dependent care credit 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

[309] 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.

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 purposes becomes less important to the extent that the support test is replaced by a residency test.[310]

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 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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310 The issue remains, however, for purposes of the head of household filing status (which retains the "maintaining a household" requirement), and to the extent that a taxpayer applies the support test instead of the residency test for the dependency exemption.

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.[311] 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.[312] 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.[313] 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

[311] 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.

[312] 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.

[313] The explanation of the President's budget proposal refers to the IRS Taxpayer Advocate's finding and states that present law may need to be clarified in order to ensure that family courts are correctly interpreting Congressional intent regarding the release of the dependency exemption by the custodial parent.

parent, and to provide that the dependency exemption cannot be allocated (or enforced against a custodial parent involuntarily) by State domestic relations courts.[314]

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 purposes of a uniform definition of qualifying child.[315] 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

No prior action.

Two legislative proposals were introduced in 2002, H.R. 5166 and H.R. 5505, which if enacted would establish a uniform definition of qualifying child. H.R. 22, the Individual and Small Business Tax Simplification Act of 2003, contains a proposed uniform definition of qualifying child.

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[314] National Taxpayer Advocate FY 2001 Annual Report to Congress, at 105 (2002).

[315] 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 of adoption assistance.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2002.

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.[316]

Prior Action

No prior action.

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[316] 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. Expansion of Tax-Free Savings Opportunities

Present Law

In general

Present law provides for a number of vehicles which 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, and encouraging saving generally.

The present-law provisions include individual retirement arrangements, tax-qualified retirement plans and similar employer-sponsored arrangements, Archer medical savings accounts, Coverdell education savings accounts, qualified tuition programs of States and private educational institutions, 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, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules regarding each type of IRA (and IRA contributions) differ.

As described below, 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 2003)[317] or the individual's compensation.[318] In the case of a married couple, 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.[319] Under so-called "catch-up contribution" rules, the otherwise applicable IRA dollar contribution limit is increased

[317] The dollar limit on IRA contributions is $3,000 for 2003 through 2004, $4,000 for 2005 through 2007, and $5,000 for 2008. After 2008, the limit is adjusted for inflation in $500 increments. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased these limits, which are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[318] Sec. 219(b).

[319] Sec. 219(c).

for individuals who have attained age 50 before the end of the taxable year.[320] The amount of the increase in the limit is $500 for 2003.[321]

Traditional IRAs

If neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan, then the individual generally may make deductible IRA contributions up to the maximum IRA contribution limit. An individual who has attained age 70-1/2 prior to the close of a year, however, is not permitted to make contributions to traditional IRAs.[322] If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction for IRA contributions is phased out for taxpayers with adjusted gross income over certain levels for the taxable year.[323] The adjusted gross income phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Single Taxpayers

Taxable years beginning in:	*Phase-out range*
2003	40,000-50,000
2004	45,000-55,000
2005 and thereafter	50,000-60,000

Joint Returns

Taxable years beginning in:	*Phase-out range*
2003	60,000-70,000
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.

[320] Sec. 219(b)(5).

[321] The additional amount permitted for catch-up contributions to an IRA is $500 for 2003 through 2005 and $1,000 for 2006 and thereafter. *Id.* The catch-up contribution is subject to the general sunset provision of EGTRRA.

[322] Sec. 219(d)(1).

[323] Sec. 219(g).

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the maximum deduction for IRA contributions is phased out for taxpayers with adjusted gross income between $150,000 and $160,000.[324]

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 contribution limit.[325]

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 70-1/2.[326] 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.[327] 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.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions.[328] Early withdrawals from an IRA generally are subject to an additional 10-percent tax.[329] That is, includible amounts withdrawn prior to attainment of age 59-1/2 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.[330]

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA up to the maximum IRA contribution limit, reduced to the extent an

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[324] Sec. 219(g)(7).

[325] Sec. 408(o).

[326] Sec. 408(a)(6).

[327] *Id*.

[328] *See* secs. 72 and 408(d).

[329] Sec. 72(t).

[330] This early withdrawal tax is similar to the early withdrawal tax that applies to qualified plans, but different exceptions apply.

individual makes contributions to any other IRA for the same taxable year.[331] The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with adjusted gross income between $95,000 and $110,000 and for joint filers with adjusted gross income between $150,000 and $160,000.[332] 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 70-1/2.[333]

Taxpayers with modified adjusted gross income of $100,000 or less generally may convert a traditional IRA into a Roth IRA.[334] 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 and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. 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 10-percent tax on early withdrawals.[335] 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) which is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.[336]

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies).[337] Distributions are deemed to come from basis first. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

Coverdell education savings accounts

Present law provides tax-exempt status to Coverdell education savings accounts, meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary.[338] The aggregate annual contributions that can be made by all contributors to

[331] Sec. 408A(c)(2).

[332] Sec. 408A(c)(3).

[333] Sec. 408A(c)(4).

[334] Sec. 408A(c)(3)(B).

[335] Sec. 408A(d).

[336] Sec. 408A(d)(2).

[337] Sec. 408A(d).

[338] Sec. 530.

Coverdell education savings accounts for the same beneficiary is $2,000 per year.[339] 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).[340]

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.[341] 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.[342]

Qualified tuition programs

Present-law provides tax-exempt status to qualified tuition programs, meaning programs established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions.[343] 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 State program, may make contributions to an account which is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account.[344] 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 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.[345] If a distribution from a qualified tuition program exceeds the qualified education expenses incurred by the beneficiary

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[339] Sec. 530(b)(1).

[340] The contribution limit and the adjusted gross income levels are subject to the general sunset provision of EGTRRA.

[341] Sec. 530(d).

[342] Sec. 530(d)(4).

[343] Sec. 529. The general sunset provision of EGTRRA applies to qualified tuition programs maintained by one or more eligible educational institutions (which may be private institutions).

[344] Sec. 529(b).

[345] Sec. 529(c)(2).

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.[346]

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.[347] 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.[348] Within limits, contributions to an Archer MSA are deductible if made by an employee and are excludable from gross income and wages if made by an employer.[349] Distributions from an Archer MSA for qualified medical expenses are not taxable.[350]

Description of Proposal

In general

The proposal replaces IRAs with two new savings vehicles, Lifetime Savings Accounts and Retirement Savings Accounts. The rules applicable to these two new types of accounts are similar; both provide for tax treatment 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 new savings vehicles is that all distributions from Lifetime Savings Accounts are tax free, whereas tax-free treatment of earnings on amounts in Retirement Savings Account applies only to distributions made after age 58 or in the event of death or disability.

Lifetime Savings Accounts

Under the proposal, an individual may make nondeductible contributions to a Lifetime Savings Account of up to $7,500 annually, regardless of the individual's age, compensation, or adjusted gross income.[351] Additionally, individuals other than the Lifetime Savings Account owner may make contributions to a Lifetime Savings Account. The contribution limit applies to all Lifetime Savings Accounts in an individual's name, rather than to the individuals making the

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[346] Sec. 529(c)(6).

[347] Sec. 220(d).

[348] Sec. 220(c).

[349] Sec. 220(b).

[350] Sec. 220(f).

[351] Total contributions to a Lifetime Savings Account for a year may not exceed $7,500, regardless of whether any distributions are taken from the Lifetime Savings Account during the year. The contribution limit is indexed for inflation.

contributions. Thus, contributors may make annual contributions of up to $7,500 each to the Lifetime Savings Accounts of other individuals but total contributions to the Lifetime Savings Accounts of any one individual may not exceed $7,500 per year. Contributions to Lifetime Savings Accounts may be made only in cash. Earnings on contributions accumulate on a tax-free basis. All distributions from an individual's Lifetime Savings Account are excludable from income.

Under the proposal, as with Roth IRAs, no minimum required distribution rules apply to a Lifetime Savings Account during the owner's lifetime.

Amounts held in Lifetime Savings Accounts may be rolled over to a member of the Lifetime Savings Account owner's family,[352] subject to normal gift tax rules.

The Administration's proposal also provides that taxpayers may convert Coverdell education savings accounts, qualified State tuition plans, and Archer MSAs into Lifetime Savings Accounts before January 1, 2004.[353] Under the proposal, amounts converted from Coverdell education savings accounts and qualified State tuition plans are not includible in income. However, amounts converted from Archer MSAs are includible in income.

Retirement Savings Accounts

Under the proposal, an individual may make nondeductible contributions to a Retirement Savings Account annually of up to $7,500[354] or, if less, the individual's compensation. Contributions to a Retirement Savings Account may be made regardless of the individual's age or adjusted gross income. As under present-law rules for IRAs, in the case of a married couple, contributions of up to the dollar limit can be made for each spouse, if the combined compensation of both spouses is at least equal to the contributed amount. Contributions to Retirement Savings Accounts may be made only in cash. Earnings on contributions accumulate on a tax-free basis.

Qualified distributions from Retirement Savings Accounts are excluded from gross income. Under the proposal, qualified distributions are distributions made after age 58 or in the event of death or disability. Any other distributions are not qualified distributions and are included in income (to the extent that the distribution exceeds basis) and are subject to an additional tax. As with Roth IRAs, distributions are deemed to come from basis first.

As with present-law Roth IRAs, the proposal provides that no minimum distribution rules apply to a Retirement Savings Account during the Retirement Savings Account owner's lifetime.

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[352] The definition of "member of the family" in section 529(e)(2) applies.

[353] Contributions to MSAs, Education Savings Accounts, and qualified State tuition plans made after enactment of the proposal are not eligible for conversion.

[354] The contribution limit is indexed for inflation.

Under the proposal, existing Roth IRAs are renamed Retirement Savings Accounts and made subject to the rules for Retirement Savings Accounts.

Additionally, the proposal provides that existing traditional IRAs may be converted into Retirement Savings Accounts. 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, 2004, the income inclusion may be spread ratably over four years. For conversions of traditional IRAs made on or after January 1, 2004, the income inclusion occurs in the year of the conversion.

Under the proposal, existing traditional IRAs that are not converted to Retirement Savings Accounts may not accept new contributions. New traditional IRAs may be created to accept rollovers from employer-sponsored retirement plans, but they cannot accept any other contributions. The proposal provides that individuals desiring to roll over an amount directly from an employer-sponsored retirement plan to a Retirement Savings Account may do so by including the rollover amount (excluding basis) in income.

Effective date

The proposal is effective in 2003.

Analysis

In general

The proposal is intended to accommodate taxpayers' changing circumstances over time by providing two new accounts that taxpayers may use for tax-favored saving over their entire lifetimes. Further, the proposal is intended to simplify saving by permitting the consolidation of existing savings accounts, providing a tax-favored saving account with no restrictions on withdrawals, and allowing individuals to make contributions to the 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 saving 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 saving 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.[355] Others have

[355] Unlike present-law IRAs, the Lifetime Savings Account does not require that contributions be no greater than compensation. Under the proposal, regardless of income, an individual may make nondeductible annual contributions to a Lifetime Savings Account of up to

argued that by increasing the return to saving, some taxpayers might actually 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.

From an economic perspective, both Lifetime Savings Accounts and Retirement Savings Accounts receive tax treatment generally equivalent to Roth IRAs. While the taxpayer does not deduct contributions to Lifetime Savings Accounts, tax is never paid on the income earned on the investment. The same is generally true for Retirement Savings Accounts as long as amounts are withdrawn in qualified distributions. However, while Lifetime Savings Accounts and Retirement Savings Accounts receive similar tax treatment to Roth IRAs, the maximum allowable annual contribution is substantially greater than that permissible to Roth IRAs. The increase in the amounts that may be contributed to tax-preferred saving accounts provides a tax incentive for further saving for those who have already contributed the maximum to existing tax-favored saving accounts. However, for taxpayers not already contributing the maximum amounts, the new accounts provide no additional inducement to save.[356] 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.

Retirement Savings Accounts also replace traditional IRAs and thereby eliminate taxpayers' ability to make deductible contributions. From an economic perspective, Retirement Savings Accounts receive tax treatment generally equivalent to traditional IRAs to which deductible contributions are made.[357] However, some would argue that the upfront deduction provides a greater psychological inducement to save, and that the elimination of the traditional

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$7,500. To the extent a taxpayer makes contributions to a Lifetime Savings Account that exceed income, then the amounts transferred in excess of income must represent a transfer of assets from existing savings and not new savings from foregoing current consumption. Additionally, individuals other than the Lifetime Savings Account owner may make contributions to a Lifetime Savings Account.

[356] 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 the Lifetime Savings Account and Retirement Savings Account will increase saving at all income levels.

[357] Whether a Retirement Savings Account 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), the traditional IRA to which deductible contributions are made is more advantageous than the Retirement Savings Account because the traditional IRA permits taxpayer to defer payment of tax until rates are lower. When marginal tax rates increase over time, a Retirement Savings Account is more advantageous.

deductible IRA may reduce saving by those who would have been able to make deductible contributions.

Taxpayers may convert Coverdell education savings accounts, qualified State tuition plans, and Archer MSAs into Lifetime Savings Accounts before January 1, 2004. Because amounts converted from Coverdell education savings accounts and qualified State tuition plans are not includible in income (whereas amounts converted from Archer MSAs are includible in income), it appears that, under the proposal, balances in current Coverdell education savings accounts and qualified State tuition program accounts would be convertible to Lifetime Savings Accounts with no income tax consequences. This would mean that earnings accumulated on Coverdell education savings accounts and qualified State tuition program balances that are converted to Lifetime Savings Accounts could be withdrawn and spent on nonqualifying expenses (for purposes of Coverdell education savings accounts and qualified State tuition programs) without income or penalty consequences. There is some scope for abuse of these transfer provisions. Ostensibly, they allow the consolidation of saving into a single vehicle for simplification purposes. However, a taxpayer with sufficient resources may effect such transfers simply to shift more saving into tax favored accounts. For example, a taxpayer could transfer $50,000 from a qualified State tuition program into the Lifetime Savings Account, and then reinvest a different $50,000 into the qualified State tuition program

The tax treatment of contributions under qualified retirement plans is essentially the same as that of traditional IRAs to which deductible contribution 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 Lifetime Savings Accounts and Retirement Savings Accounts 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 Lifetime Savings Accounts and Retirement Savings Accounts, 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 annually contribute $7,500 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. Additionally, business owners could selectively make contributions to the Lifetime Savings Accounts of highly compensated employees only. This undermines the principle of promoting savings for rank-and-file employees.

Thus, the proposal may reduce qualified 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 plan contribute to the new savings vehicles.

Complexity

The proposal has elements that may both increase and decrease tax law complexity. On the one hand, the proposal provides new savings options to individuals, which may increase complexity to the extent that taxpayers open new Lifetime Savings Account and Retirement Savings Account accounts without consolidating existing tax-preferred savings into such 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 contribute to deductible or non-deductible IRAs for those taxpayers eligible to contribute to both. However, since employer-based qualified plans receive the same tax treatment as deductible IRAs, the increased scope for contributing to Roth-type savings vehicles, in terms of eligibility and dollar limits, likely means that many more taxpayers will face a choice of how to balance their savings between deductible and non-deductible saving. Notwithstanding, the ability to make contributions to Lifetime Savings Accounts and Retirement Savings Accounts without limitations based on age or income level, the nondeductibility of all contributions to Lifetime Savings Accounts and Retirement Savings Accounts, and the lack of restrictions on Lifetime Savings Account withdrawals, is likely to decrease complexity.

Prior Action

No prior action.

D. 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.

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 plans and defined contributions 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"),[358] governmental eligible deferred compensation plans ("section 457

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[358] Sec. 403(b).

plans"),[359] SIMPLE IRAs,[360] and salary-reduction simplified employee pensions ("SARSEPs").[361]

<u>Limits on contributions to qualified defined contribution plans</u>

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 ($40,000 for 2003). Annual additions are the sum of employer contributions,[362] employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

<u>Nondiscrimination requirements applicable to qualified retirement plans</u>

<u>In general</u>

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. These requirements include the minimum coverage rules, the general requirement that contributions or benefits not discriminate in favor of highly compensated employees, and the top-heavy rules.

For purposes of the minimum coverage rules and the general rule prohibiting discrimination in contributions or benefits, 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 2003) or (b) at the election of the employer had compensation for the preceding year in excess of $90,000 (for 2003) and was in the top 20 percent of employees by compensation for such year.[363] A nonhighly compensated employee is an employee other than a highly compensated employee.

<u>Minimum coverage rules</u>

Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees; (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test that considers the make-up of the group of employees covered by the plan, and the business reasons for covering the group, and

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[359] Sec. 457.

[360] Sec. 408(p).

[361] Sec. 408(k).

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

[363] Sec. 414(q).

compares the benefits received by highly compensated employees and nonhighly compensated employees under all plans of the employer.[364] In general, an employee is considered to benefit under a defined contribution plan if the employee receives an allocation to his or her account of contributions made to the plan. Under a special rule, an employer that operates separate lines of business may apply the minimum coverage requirements separately with respect to employees in each separate line of business.[365]

General nondiscrimination requirement rules

In general.–Under the general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.[366] 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.[367]

Testing the amount of nonelective contributions.–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.[368] In order to satisfy a safe harbor, a defined contribution plan must generally provide contributions that are a uniform percentage of compensation for all employees, taking into account permitted disparity (discussed below), and must meet certain other requirements. If a plan does not satisfy one of the safe harbors, it is subject to the general test, which involves a determination of individual contribution rates for employees in the plan and a comparison of the rates of the highly compensated employees and the nonhighly compensated employees. These tests generally apply only to nonelective employer contributions under a plan. Elective deferrals, matching contributions, and after-tax employee contributions are subject to separate testing as described below.

Cross-testing.–Cross-testing is a mechanism by which amounts contributed for employees under a defined contribution plan are converted to equivalent benefits commencing at normal retirement age, and the equivalent benefits provided to highly compensated and nonhighly compensated employees are analyzed under the general test. As a result of the actuarial computations and assumptions used in cross-testing, a smaller contribution for a younger employee and a larger contribution for an older employee are considered to result in the same (or comparable) equivalent benefits at normal retirement age. Because the highly compensated employees in a business tend to be older, cross-testing can allow an employer to

[364] Sec. 410(b).

[365] Sec. 410(b)(5) and sec. 414(r).

[366] Sec. 401(a)(4).

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

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

provide higher contributions for highly compensated employees without failing the nondiscrimination requirements. Under recently issued regulations, in order for cross-testing to apply to a plan, the plan must meet one of several contributions requirements. For example, under one requirement, each nonhighly compensated must have a contribution rate that is at least one third of the highest contribution rate applicable to a highly compensated employee.

Permitted disparity.–The permitted disparity rules allow higher contributions or benefits to be provided to higher-paid employees without violating the nondiscrimination requirements.[369] The rationale for permitted disparity lies in the fact that an employer pays social security taxes on an employee's compensation only up to the social security wage base, and social security benefits are based only on that compensation, so the employer may make up the difference in the contributions or benefits provided under its qualified retirement plan. Under the nondiscrimination rules, permitted disparity can be incorporated into a design-based safe harbor or can be taken into account as part of the general test or cross-testing.

In the case of a defined contribution plan, the permitted disparity rules allow the employer to provide a higher (that is, disparate) rate of contribution with respect to compensation in excess of the social security wage base (the "excess contribution rate") than the rate provided on compensation up to the social security wage base (the "base contribution rate"), subject to a limit. Under this limit the excess contribution rate cannot exceed the lesser of (1) twice the base rate or (2) the base rate plus 5.7 percent.

Top-heavy rules

Under present law, a top-heavy plan is a qualified retirement plan under which cumulative benefits are provided primarily to key employees.[370] A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60 percent of the total account balances under the plan. An employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of $130,000 (adjusted for inflation in $5,000 increments), (2) a five-percent owner, or (3) a one-percent owner with compensation in excess of $150,000.

A defined contribution plan that is top-heavy must provide (1) minimum employer contributions to employees who are not key employees and (2) more rapid vesting for plan participants who are not key employees. The miminum contribution is the lesser of (1) three percent of compensation, or (2) the percentage of compensation at which contributions were made for key employees.

[369] Secs. 401(a)(5)(C) and 401(l).

[370] Sec. 416.

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. 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 $12,000 for 2003.[371] 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 $2,000 for 2003.[372] An employee's elective deferrals must be fully vested.

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.[373] 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

[371] 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 $13,000 for 2004, $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.

[372] The additional amount permitted for catch-up contributions increases to $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments.

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

notice requirement (a "safe harbor section 401(k) plan").[374] 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.[375]

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 deferral of a nonhighly compensated employee.

A safe harbor section 401(k) plan is not subject to the top-heavy rules that generally apply to qualified retirement plans.

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".[376] 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

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

[375] The permitted disparity rules may not be used in satisfying these contribution requirements.

[376] Sec. 401(m).

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, 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.[377]

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

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.[378] The maximum annual deferral under such a plan generally is the lesser of (1) $12,000 for 2003 (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 $2,000 for 2003 (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 $8,000 for 2003 (increasing to $10,000 by 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 $1,000 for 2003 (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 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.

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[378] 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.

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 (including the top-heavy rules). 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 2003) 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 ($12,000 for 2003, 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 $1,000 for 2003 (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 59-1/2, 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 59-1/2, (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.

Definition of compensation

Qualified retirement plans

Various definitions of compensation apply for different qualified retirement plan purposes. For purposes of the limits on contributions and benefits under a qualified retirement plan, compensation is generally defined as compensation from the employer that is includible in the income, plus certain elective contributions that are not included in gross income (i.e., elective deferrals under a section 401(k) plan or a section 403(b) plan, elective contributions under a section 457 plan, salary reduction contributions under a cafeteria plan, and certain qualified transportation fringe benefits).[379] However, regulations deviate from this definition for certain types of compensation such as restricted stock and moving expense reimbursements. The regulations also provide alternative definitions of compensation based on compensation that is subject to income tax withholding or which must be reported on a Form W-2. This definition is also used to determine status as a highly compensated employee for purposes of the nondiscrimination requirements or status as a key employee for purposes of the top-heavy provisions and to apply the limits on deductible contributions to a plan.

Another definition of compensation applies for purposes of the application of the various nondiscrimination requirements.[380] This definition generally is based on the definition of compensation that applies for purposes of the limits on contributions and benefits, but the employer may elect not to include elective contributions. In addition, the use of alternative methods of determining compensation is authorized to the extent that the use of an alternative method does not discriminate in favor of highly compensated employees.

[379] Sec. 415(c)(3).

[380] Sec. 414(s).

Other plans

The definition of compensation that applies for purposes of the limits on contributions and benefits under a qualified retirement plan, also applies for purposes of the limits on deferrals under a section 457 plan and for purposes of determining eligibility to participate. However, other definitions of compensation apply to section 403(b) plans, SIMPLE plans, and for other SEP purposes.

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.

The proposal also simplifies the qualification rules for defined contribution plans generally. The proposal does not affect the rules applicable to qualified defined benefit plans.

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, 2004.

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 $40,000 (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 all contributions made for the employee (including employee pretax and after-tax contributions, employer matching contributions, and qualified nonelective contributions) 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 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.

Changes to general defined contribution plan rules

The proposal makes various modifications to the rules applicable to defined contribution plans generally.

The proposal modifies the minimum coverage requirements, so that the percentage of nonhighly compensated employees who are covered by a plan must be at least 70 percent of the percentage of highly compensated employees covered by the plan (the "percentage test"). Accordingly, the alternative tests, i.e., covering 70 percent of nonhighly compensated employees and the average benefit test, are repealed. Existing rules for applying the percentage test still apply.

Under the proposal, the cross-testing and permitted disparity rules are no longer available in applying the general nondiscrimination requirement to employer contributions that are not subject to the ERSA nondiscrimination tests. In addition, the proposal repeals the present-law top-heavy rules for defined contribution plans.

Under the proposal, a uniform definition of compensation applies, defined as all compensation subject to income tax withholding that is required to be reported on a Form W-2, plus elective deferrals under an ERSA.

In addition, "highly compensated employee" is defined as any employee with compensation for the prior year in excess of the social security wage base for that year ($87,000 for 2003). Thus, the five percent owner category of highly compensated employee and the top-paid group election under present law are repealed.

Effective date

The proposal is effective for years beginning after December 31, 2003, including the option of designating employee elective contributions as Roth contributions.

Analysis

Policy and complexity issues relating to employer-sponsored retirement plans[381]

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 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.

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[381] 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.

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. Reducing the complexity associated with ADP and ACP testing reduces the compliance costs associated with a plan, making employers more likely to offer plans, thus increasing coverage and participation. Others argue that the present-law section 401(k) safe harbor 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, if the proposal weakens the nondiscrimination requirements applicable to elective deferrals, after-tax employee contributions, and matching contributions, such effect is balanced by the proposed modifications to the minimum coverage requirements (discussed below), which apply to ERSAs as well as to other plans and which will have the general effect of increasing coverage for rank-and-file employees. Some may also 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.

<u>Consolidation of various types of employer-sponsored plans</u>

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.[382] 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 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 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.

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[382] 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).

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.[383] 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 $7,500 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.

Analysis of proposals related to general defined contribution plan rules

Modification of the minimum coverage requirements

The proposal simplifies the minimum coverage rules by repealing the average benefit test. Some view the present-law average benefit test as a means for providing plan coverage that discriminates in favor of highly compensated employees. Therefore, from this perspective, repeal of the average benefit test serves both the goal of simplification and the goal of nondiscrimination. Others argue that the flexibility of the average benefit test accommodates the needs of an employer with a varied workforce (e.g., multiple divisions or types of businesses). They argue that the percentage test is too rigid a test and prevents an employer from designing plans that are appropriate for different segments of an employer's workforce. On the other hand, some argue that the necessary flexibility is provided under present law by the separate line of business rules and by the fact that certain types of employees can be excluded in applying the test.

Repeal of top-heavy requirements

Repeal of the top-heavy rules provides simplification because it eliminates one additional aspect of nondiscrimination testing. Some argue that the complexity added by the top-heavy rules is unnecessary because the present-law nondiscrimination requirements are sufficient to ensure that rank-and-file employees receive adequate benefits compared with highly compensated employees. They argue that the changes in the nondiscrimination rules under the proposal would further strengthen the nondiscrimination rules, further reducing any need for top-heavy rules. In addition, because the top-heavy rules primarily affect small businesses, some argue that they are an impediment to the establishment of qualified retirement plans by such businesses.

Others point out that the minimum coverage requirements and the general nondiscrimination requirement are generally applied on the basis of contributions or benefits

[383] The proposals related Lifetime Savings Accounts and Retirement Savings Accounts are discussed in Part V.C of this document.

provided to highly paid and rank-and-file employees for the current plan year, while the top-heavy requirements are applied on the basis of the cumulative amounts provided under the plan. They argue that, regardless of whether plans satisfy the minimum coverage and nondiscrimination requirements on an annual basis, the top-heavy rules are necessary to assure that the tax subsidy provided to a qualified retirement plan sufficiently benefits rank-and-employees over the long term as well as in any given year.

Elimination of permitted disparity and cross-testing rules

Elimination of the permitted disparity and cross-testing rules reduces the complexity involved in nondiscrimination testing. Some view these rules as permitting benefits or contributions that discriminate in favor of highly compensated employees. They argue that, like the repeal of the average benefit test, repeal of the permitted disparity and the cross-testing rules serves both the goal of simplification and the goal of nondiscrimination.

Others argue that the permitted disparity rules are justified because they coordinate the design of the social security system (a mandatory employment-based retirement income system) with the voluntary qualified retirement plan system. In addition, some argue that the effect of the cross-testing rules is to allow an employer to provide benefits to older workers under a defined contribution plan that are equivalent to those provided under a defined benefit plan without assuming the additional requirements and costs associated with defined benefit plans. They argue that recent changes to the cross-testing rules adequately control against prohibited discrimination.

Definitions of compensation and highly compensated employee

Use of a uniform definition of compensation for all defined contribution plan purposes simplifies compliance with the qualification requirements.[384] The use of different definitions of compensation for purposes of different qualified retirement plan requirements produces unnecessary complexity without affecting the application of these requirements in any meaningful way. On the other hand, for purposes of determining contributions or benefits, a qualified retirement plan may contain a particular definition of compensation that is appropriate for the business maintaining the plan. Some argue that flexibility in the definition of compensation that must be used for the purpose of satisfying the qualification requirements makes it more likely that the plan's definition may be used for this purpose.

The proposal simplifies the definition of highly compensated employee by eliminating the five percent owner category and the top-paid group election. In addition, the proposal uses the social security wage base ($87,000 for 2003) as the compensation threshold for highly compensated employee status, rather than an indexed dollar amount ($90,000 for 2003). As a result, highly compensated employee status is determined by a single criterion, i.e., whether the

[384] The proposal is similar to a recommendation made by the Joint Committee staff 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, at Vol. II, pages 166-173.

employee's compensation for the prior year exceeded the social security wage base, rather than the multiple criteria under present law. The elimination of the five percent owner category of highly compensated employee reflects a policy change from present law and is likely to result in fewer owners being treated as highly compensated employees, which some argue allows inappropriate discrimination.

Some argue that an individual whose compensation does not exceed the social security wage base should not be considered highly compensated, even if the individual owns a significant portion of the business maintaining the plan. On the other hand, depending on the structure of a business, an owner may have the ability to manipulate the amount of compensation received from year to year in order to avoid highly compensated employee status. This could enable the individual to receive contributions for some years without providing comparable contributions to rank-and-file employees. In addition, some consider it appropriate to include business owners among highly compensated employees for purposes of the nondiscrimination requirements, regardless of compensation level, because of their control over business decisions.

The use of the social security wage base in determining highly compensated employee status may enable an employer to more easily coordinate the determination of highly compensated employees with its payroll system. In addition, it would no longer be necessary for employers (or the IRS) to track separate indexed amounts for purposes of highly compensated employee status and payroll tax purposes. Currently, the wage base ($87,000) is somewhat lower than the dollar threshold for determining highly compensated employee status ($90,000).[385] Therefore, use of the wage base, particularly in combination with the elimination of the top-paid group election, is likely to increase the number of employees treated as highly compensated.

With respect to elimination of the top-paid group election, permitting elections that may vary from year to year increases complexity as employers that may benefit from the election may feel it necessary to run tests under both options. In addition, by use of the election, it is possible for employees earning very high compensation (compensation in excess of $90,000 for 2003) to be treated as nonhighly compensated for testing purposes if the employer has a sufficient percentage of high-paid employees in its workforce (i.e., if employees earning more than $90,000 are in the top paid 20 percent of employees). This would allow some employers to effectively eliminate benefits for low- and moderate-wage workers without violating the nondiscrimination rules. The proposal may help ensure that the definition of highly compensated employee better reflects the purpose of promoting meaningful benefits for low- and moderate-wage workers, not only the high paid. On the other hand, some argue that the greater flexibility provided to employers under present law is appropriate. Without the flexibility in testing, some employers may reduce plan benefits or choose to terminate plans, reducing aggregate pension coverage and potentially reducing aggregate retirement saving.

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[385] Because of differences in the indexing methods applied to the social security wage base and the dollar threshold currently use to determine highly compensated employee status, the relationship of the two amounts in future years is not clear.

Prior Action

No prior action.

VI. EXPIRING PROVISIONS

A. Permanent Extension of Certain Expiring Provisions

1. Permanently extend provisions expiring in 2010

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") made a number of changes to the Federal tax laws, including: reducing individual tax rates, repealing the estate tax, increasing and expanding various child-related credits, providing tax relief to married couples, providing additional education-related tax incentives, increasing and expanding various pension and retirement-saving incentives, and providing individuals relief relating to the alternative minimum tax. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974, the Act included a "sunset" provision, pursuant to which the provisions of the Act expire at the end of 2010. Specifically, the Act's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010.

The Act provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though the Act had never been enacted. For example, the estate tax, which the Act repeals for decedents dying in 2010, will return as to decedents dying after 2010, in pre-Act form, without the various interim changes made by the Act (e.g., the rate reductions and exemption equivalent amount increases applicable to decedents dying before 2010). Similarly, the top individual marginal income tax rate, which the Act gradually reduces to 35 percent by 2006, will return to its pre-Act level of 39.6 percent in 2011 under present law. Likewise, all other provisions of the Code and ERISA will be applied as though the relevant provisions of the Act had never been enacted.

Description of Proposal

The proposal repeals the sunset provision of the Act and thus permanently extends all provisions of the Act 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.[386]

Effective date.–The proposal is effective at date of enactment.

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

Analysis

In general

The policy merits of permanently extending the provisions of the Act that expire at the end of 2010 depend on considerations specific to each provision. In general, however, advocates of eliminating the sunset provision may argue that it was never anticipated that the sunset actually would be allowed to take effect, and that eliminating it promptly would promote stability and rationality in the tax law. In this view, if the sunset were eliminated, other rules of the Act that phase in or phase out provisions over the immediately preceding years would be made more rational. On the other hand, others may argue that certain provisions of the Act would not have been enacted at all, or would not have been phased in or phased out in the same manner, if the sunset provision had not been included in the Act.

Complexity issues

The present-law sunset provision arguably contributes to complexity by requiring taxpayers to contend with (at least) two different possible states of the law in planning their affairs. For example, under the sunset provision, an individual planning his or her estate will face very different tax regimes depending on whether the individual dies in 2010 (estate tax repealed) or 2011 (estate tax not repealed). This "cliff effect" requires taxpayers to plan an estate in such a way as to be prepared for both contingencies, thereby creating a great deal of complexity. On the other hand, some may argue that this kind of uncertainty is always present to some degree -- with or without a sunset provision, taxpayers always face some risk that the Congress will change a provision of law relevant to the planning of their affairs. Others may acknowledge this fact, but nevertheless argue that the sunset provision creates an unusual degree of uncertainty and complexity as to the areas covered by the Act, because they consider it unlikely that the sunset will actually go into effect. In this view, the sunset provision leaves taxpayers with less guidance as to the future state of the law than is usually available, making it difficult to arrange their affairs. In addition to the complexity created by the need to plan for the sunset, uncertainty about the timing and details of how the sunset might be eliminated arguably creates further complexity.

Even if it is assumed that the sunset provision will take effect, it is not clear how the sunset would apply to certain of the Act's provisions. It would be relatively simple to apply the sunset to some provisions, such as the individual rate reductions. With respect to other provisions, however, further guidance would be needed as to the effect of the sunset. For example, if the Code will be applied after 2010 as if the Act had never been enacted, then one possible interpretation of the pension provisions is that contributions made while the Act was in effect will no longer be valid, possibly resulting in the disqualification of plans. While this result was likely not intended, without further guidance taxpayers may be unsure as to the effect of the sunset.

More broadly, in weighing the overall complexity effects of the present-law sunset and the proposed sunset repeal, some would point out that the sunset provision is not the only feature of the Act that generates "cliff effects" and similar sources of uncertainty and complexity for taxpayers. For example, under the Act's estate tax provisions, a decedent dying in 2008 has an exemption equivalent amount of $2 million, one dying in 2009 has an exemption equivalent amount of $3.5 million, and one dying in 2010 effectively has an infinite exemption. Thus, the estates of individuals at certain wealth levels will incur significant estate tax if they die in 2008, but none at all if they die in 2009; the estates of individuals at other wealth levels will incur significant estate tax if they die in 2009, but none at all if they die in 2010. These discontinuities are not caused by the sunset provision, but they generate a similar sort of uncertainty and complexity for many taxpayers. Similar phase-ins and phase-outs are found in other provisions of the Act and generate complexity and uncertainty, irrespective of whether the Act as a whole sunsets or not. In light of these issues, some may argue that a more detailed reconsideration of the Act or certain of its provisions would better serve the goal of tax simplification.

Beyond phase-ins and phase-outs, some may argue that the Act included other provisions that increased the complexity of the Code, and that allowing those provisions to expire at the end of 2010 (or effectively requiring that they be reconsidered before then) may reduce complexity, albeit potentially years in the future. Others would argue that some of the Act's provisions reduced complexity, such as the repeal of the overall limitation on itemized deductions and changes relating to the earned income tax credit, and that permanently extending these provisions would contribute to simplification of the tax laws.

Prior Action

An identical proposal was included in the President's Fiscal Year 2003 Budget proposals.[387]

2. 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.

A 20-percent research tax credit also applied 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

[387] This or a similar proposal has been included in a number of bills introduced in the 107th Congress (e.g., H.R. 2316, H.R. 2327, and H.R. 2599). In addition, other bills have been introduced that would repeal the sunset of the Act as to certain provisions (e.g., H.R. 2143 (estate tax and related provisions), H.R. 2212 (individual income tax rate reductions), and H.R. 3050 (same)). The Senate also has passed, as Senate Amendment 2850 to S. 1731 (an agriculture reauthorization bill), a provision expressing the Sense of the Senate that the Act's sunset should be repealed as to the estate tax provisions (i.e., that estate tax repeal should be made permanent).

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 percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.[388]

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)).

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[388] 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)).

Alternative incremental research credit regime

Taxpayers are allowed to elect an alternative incremental research credit regime.[389] If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible 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).[390]

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

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[389] Sec. 41(c)(4).

[390] 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).

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 useful life extending beyond the current year must be capitalized.[391] 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.[392] However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. It is difficult to determine whether, at the present

[391] 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).

[392] This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

levels of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency. There is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.[393]

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.

The scope of present-law tax expenditures on research activities

The tax expenditure related to the research and experimentation tax credit is estimated to be $5.1 billion for 2003. The related tax expenditure for expensing of research and development expenditures is estimated to be $3.8 billion for 2003 growing to $6.2 billion for 2007.[394] As noted above, the Federal Government also directly subsidizes research activities. For example, in fiscal 2002 the National Science Foundation made $3.7 billion in grants, subsidies, and contributions to research activities, the Department of Defense financed $9.6 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 and nuclear physics and $150 million for research in advance scientific computing.[395]

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[393] *See* Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, XCIV, (1992), M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993, and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43.

[394] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007* (JCS-5-03), December 19, 2002, p. 18.

[395] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004*, Appendix, pp.965, 273-276, and 369.

Table 12 and Table 13 present data for 2000 on those industries that utilized the research tax credit and the distribution of the credit claimants by firm size. In 2000, more than 15,000 taxpayers claimed more than $7 billion in research tax credits. Taxpayers whose primary activity is manufacturing claimed more than 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 13 documents, a large number of small firms are engaged in research and were able to claim the research tax credit.

Table 12.–Percentage Distribution of Firms Claiming Research Tax Credit and Percentage of Credit Claimed by Sector, 2000

Industry	Percent of Corporations	Percent of total R & E Credit
Manufacturing	5.72	68.22
Information	2.34	15.99
Professional, Scientific, and Technical Services	13.66	8.88
Wholesale Trade	7.04	2.23
Finance and Insurance	4.39	1.94
Retail Trade	11.91	0.69
Holding Companies	0.94	0.52
Transportation and Warehousing	3.18	0.31
Health Care and Social Services	6.07	0.29
Mining	0.65	0.20
Agriculture, Forestry, Fishing and Hunting	2.79	0.06
Administrative and Support and Waste Management and Remediation Services	4.20	0.15
Construction	11.76	0.12
Other Services	6.27	0.04
Arts, Entertainment, and Recreation	1.94	0.04
Real Estate and Rental and Leasing	10.55	0.04
Accommodation and Food Services	5.10	0.02
Educational Services	0.73	0.02
Utilities	(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 13.–Percentage Distribution of Firms Claiming Research Tax Credit and of Amount of Credit Claimed by Firm Size, 2000

Asset Size ($)	Percent of Firms	Percent of Credit Claimed
0	6.52	1.66
1 to 100,000	51.18	0.08
100,000 to 250,000	15.98	0.12
250,000 to 500,000	9.59	0.24
500,000 to 1 Million	6.76	0.50
1 to 10 Million	8.37	4.14
10 to 50 Million	1.02	6.12
50 million and more	0.58	87.14

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 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.[396] 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.[397]

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

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[396] 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.

[397] It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise--so called marginal research expenditures--need be subject to the credit to have a positive incentive effect.

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.[398]

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.[399] Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

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[398] 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 <u>decrease</u> in price results in an <u>increase</u> 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.

[399] In a 1983 study, the Treasury Department used an elasticity of .92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded that the estimate might be biased upward. *See*, Department of the Treasury, The Impact of Section 861-8 Regulation on Research and Development, p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerable smaller. For example, the General Accounting Office summarizes: "These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit's impact." *See*, *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: "While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3." *See*, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191.

More recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to fully appreciate the incentive structure of the revised credit. *See,* Bronwyn H. Hall, "R&D Tax Policy During the 1980s: Success or Failure?" in James M. Poterba (ed.), *Tax Policy and the Economy*, 7, pp. 1-35 (Cambridge: The MIT Press, 1993). Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based

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 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.[400]

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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*, 88, May, 1998, pp. 298-302.

[400] 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.

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.[401]

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 section 174.[402] An executive in a large technology company has identified the research credit as

[401] 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.

[402] 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.

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.[403]

Prior Action

The President's fiscal year 2003 budget proposal contained an identical provision.

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).

[403] David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, 50, September 1997, pp. 487-493.

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.

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.

3. 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 designed to 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

No prior action.

4. Permanently extend and expand disclosure of tax return information for administration of student loans

Present Law

Income-contingent loan verification program

Present law prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Code.[404] An exception is provided for disclosure to the

[404] Sec. 6103.

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.[405]

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. The Department of Treasury has reported that the Internal Revenue Service processes approximately 100,000 consents per year for this purpose.[406]

The Department of Education disclosure authority is scheduled to expire after September 30, 2003.

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 areas of return information for the purposes of information verification of student aid applications.[407] 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).

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 computer calculates an expected family contribution that determines the amount of aid a student will receive. All Department of Education financial aid comes directly through the school or various lenders.

The Department of Education requires schools to verify financial aid information through a process whereby 30 percent of the applicants are selected to 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.

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[405] Sec. 6103(l)(13).

[406] Department of Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (February 2003), p. 133.

[407] Pub. L. No. 105-244, sec. 483 (1998).

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 mailing address of the taxpayer to the Department of Education.[408] To assist in locating the defaulting taxpayer, the Department of Education may redisclose the mailing address to the personnel of certain lenders, States, nonprofit agencies, and educational institutions whose duties relate to the collection of student loans.[409]

Safeguard procedures and recordkeeping

Federal and State agencies that receive returns and return information are required to also maintain a standardized system of permanent records on the use and disclosure of that information. 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 is required to review the safeguards established by such agencies on a regular basis.

Description of Proposal

The proposal allows the Internal Revenue Service to match income data on student aid applications with the applicant's tax data to prevent over-awards in Federal Pell grants and other student aid programs.

According to the Department of Treasury, the proposal establishes permanent authority to disclose the return information described above and also earnings from employment, Federal income tax liability, and type of tax return filed. Specifically, 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). It is understood that under the proposal, if an applicant is unable to resolve the discrepancy with the school, such applicant would have to resolve the discrepancy by contacting the Internal Revenue Service.

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. The proposal allows disclosure to the schools of the fact of a discrepancy between an item on the financial aid application and return information (e.g., AGI is discrepant), but not the details of the discrepancy (e.g., not the amount of AGI that is discrepant).

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[408] Sec. 6103(m)(4).

[409] *Id.*

It is understood that the proposal is imposes the present-law safeguards applicable to disclosures to Federal and State agencies on disclosures to the Department of Education and its contractors. The proposal also requires the Department of Education to monitor its contractors.

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

Analysis

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.[410] 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.[411] 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.

[410] S. Prt. No. 103-37 at 54 (1993).

[411] 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.

Critics might argue that the disclosure of sensitive return information of millions[412] 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.

Contractors

The proposal also 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.

Prior Action

A similar proposal was contained in the President's fiscal year 2003 budget proposal.

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[412] 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.*

B. Temporary Extension of Expiring Provisions

1. 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.[413]

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[413] 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).

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

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

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.[414] 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

[414] 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.

additional earnings. Increased wages resulting from the WOTC may be viewed as a partial offset to these high marginal tax rates. In addition, it may be the case that even if the credit has little effect on observed wages, credit-eligible individuals may have increased earnings due to increased employment.

The structure of the WOTC (the 40-percent credit rate for the first $6,000 of qualified wages) appears to lend itself to the potential of employers churning employees who are eligible for the credit. This could be accomplished by firing employees after they earn $6,000 in wages and replacing them with other WOTC-eligible employees. If training costs are high relative to the size of the credit, it may not be in the interest of an employer to churn such employees in order to maximize the amount of credit claimed. Empirical research in this area has not found an explicit connection between employee turnover and utilization of WOTC's predecessor, the Targeted Jobs Tax Credit ("TJTC").[415]

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.[416]

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

[415] *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.

[416] 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.[417] In these latter cases, the TJTC provided a cash benefit to the firm, without affecting the decision to hire a particular worker.

Prior Action

Separate proposals to extend the two credits but which did not provide for their combination were included in the President's fiscal year 2001, 2002, and 2003 budget proposals.[418]

2. Extend alternative minimum tax relief for individuals

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit,[419] 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.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in

[417] 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.

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

[419] A portion of the child credit may be refundable.

taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing 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.

Description of Proposal

The proposal allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits.

Effective date.–The proposal is effective for taxable years beginning in 2004 and 2005.

Analysis

Allowing the personal credits to offset the regular tax and alternative minimum tax results in significant simplification. Substantially fewer taxpayers need to complete the alternative minimum tax form (Form 6251), and the forms and worksheets relating to the various credits can be simplified.[420]

The Congress, in legislation relating to expiring provisions in recent years, has determined that allowing these credits to fully offset the regular tax and alternative minimum tax would not undermine the policy of the individual alternative minimum tax and would promote the important social policies underlying each of the credits.

The following example compares the effect of not extending minimum tax relief with the effect of the proposal extending minimum tax relief:

Example.–Assume in 2004, a married couple has an adjusted gross income of $70,000, they do not itemize deductions, and they have four dependent children, two of whom are eligible for the child tax credit and two of whom are eligible for a combined $3,000 HOPE Scholarship credit. The couple's net tax liability without an extension of the rules, and with an extension, are computed as shown in Table 14.

[420] 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 14.–Comparison of Individual Tax Liability Without Extension of Rules and With Extension

	Without Extension	Proposal (With Extension) [421]
Adjusted gross income	$70,000	$70,000
Less standard deduction	8,150	8,150
Less personal exemptions (6 @ $3,100)	18,600	18,600
Taxable income	43,250	43,250
Regular tax	5,877	5,877
Tentative minimum tax	5,460	5,460
HOPE Scholarship credit before limitation	3,000	3,000
Tentative minimum tax limitation:		
Regular tax	5,877	5,877
Less tentative minimum tax	5,460	0
Limitation	417	5,877
HOPE Scholarship credit	417	3,000
Child tax credit	1,200	1,200
Net tax	4,260	1,677
Net tax reduction		2,583

Prior Action

A substantially similar proposal was contained in the President's Fiscal Year 2003 budget proposal.[422]

3. Extension of D.C. Enterprise Zone

Present Law

The 1997 Act 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,

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[421] The example assumes the only change to present law is the extension of this provision.

[422] The Job Creation and Worker Assistance Act of 2002 extended for 2002 and 2003 the rules allowing certain nonrefundable credits to offset the regular tax and the alternative minimum tax.

2003.[423] 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;[424] 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.[425]

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 on the date of enactment.

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[423] 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.

[424] 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.

[425] Sec. 1400A(a).

Analysis

Complexity issues

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.

Policy issues

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.

Prior Action

No prior action.

4. Expansion of 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.[426]

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[426] 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

Description of Proposal

The proposal extends the first-time homebuyer credit for two years, through December 31, 2005.

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

Analysis

Complexity issues

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.

Policy issues

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.

Prior Action

No prior action.

5. 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.

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.

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 December 31, 2003, 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. The new reporting requirements apply to bonds issued after December 31, 2003.

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.[427] 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

[427] 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.

local government that benefits from the bond proceeds.[428] To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 on the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal Government would make outlays of $100 in interest payments, but would recoup $28 of that in tax receipts, for a net budgetary cost of $72, as before. Similarly, the bondholder/taxpayer would receive a taxable $100 in interest, and would owe $28 in taxes, for a net gain of $72, as before. The State or local government also would be in the same situation in both cases.

The proposed tax credit regime to subsidize public school investment raises some questions of administrative efficiencies and tax complexity (see above). Because potential purchasers of the zone academy bonds must educate themselves as to whether the bonds qualify for the credit, certain "information costs" are imposed on the buyer. Additionally, since the determination as to whether the bond is qualified for the credit ultimately rests with the Federal Government, further risk is imposed on the investor. These information costs and other risks 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

[428] 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.

bond is stripped. In the case of a direct payment of interest, by contrast, tax- exempt organizations would be able to enjoy such benefits.

Prior Action

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

6. 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.[429]

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."[430] 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.[431] The original use of the property must be by the donor or the donee,[432] 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

[429] Sec. 170(e)(1).

[430] Secs. 170(e)(4) and 170(e)(6).

[431] 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).

[432] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

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 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.[433]

Description of Proposal

The proposal extends the enhanced deduction to apply to donations made 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

[433] Sec. 170(e)(6)(C).

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 fair market value of the computer technology.[434] 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.[435]

Prior Action

No prior action.

The "CARE Act of 2003," as marked up by the Senate Finance Committee on February 5, 2003, contains a similar proposal that would extend the enhanced deduction beyond the present-law expiration date to contributions made during any taxable year beginning before January 1, 2006.

7. 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.

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[434] 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.

[435] 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*, 7-8.

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

No prior action.

8. Extension of 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. Public Law 104-117[436] extended the statutory authorization for these user fees[437] through September 30, 2003.

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[436] 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).

[437] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100-203, December 22, 1987).

Description of Proposal

The proposal extends the statutory authorization for these user fees through September 30, 2005.

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

No prior action.

9. Extend provisions permitting disclosure of return information relating to terrorist activity

Present Law

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.[438]

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.

[438] 18 U.S.C. 2331.

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 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.

Special rule for *ex parte* court ordered disclosure initiated by the IRS.--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.

Disclosure of return information other than by ex parte court order

Disclosure by the IRS without a request.–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.

Disclosure upon written request of a Federal law enforcement agency.–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)[439] 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 for an additional year 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 on the date of enactment.

[439] A taxpayer's identity is treated as not having been supplied by the taxpayer or his representative.

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 one year, a 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

No prior action.

VII. RESPOND TO FOREIGN SALES CORPORATION / EXTRATERRITORIAL INCOME DECISIONS

A. 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;[440] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[441]

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.

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[440] "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.

[441] "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.

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 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,[442] and a WTO Appellate Body later affirmed the Panel's findings (but modified the Panel's reasoning in part).[443] 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.

Description of Proposal

The President's budget submission provides a general discussion of the FSC/ETI issue, setting forth two main principles: (1) the United States should comply with the decisions of the WTO by repealing the ETI regime, making no attempt to replicate the regime's benefits through minor changes to present law or through adoption of a similar replacement regime; and (2) the repeal of the ETI regime should be accompanied by other changes to the U.S. international tax rules, with a view to ensuring that the U.S. tax system does not impose undue burdens on U.S.-based companies competing in the global marketplace. The submission identifies several "areas of attention" in this regard, including: (1) the foreign base company sales and services rules under subpart F;[444] (2) separate foreign tax credit limitation categories, or "baskets";[445] (3) interest expense allocation rules for foreign tax credit purposes;[446] and (4) the overall foreign loss recapture rules for foreign tax credit purposes.[447]

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[442] 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.

[443] 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.

[444] Sec. 954(d) and (e).

[445] Sec. 904(d).

[446] Sec. 864(e).

[447] Sec. 904(f).

Analysis

The budget submission outlines general principles that the Department of the Treasury believes should govern the U.S. response to the FSC/ETI decisions of the WTO, rather than proposing a specific set of measures. Accordingly, no detailed policy or complexity analysis is appropriate with respect to the submission in this regard.

Prior Action

In July 2002, Mr. Thomas, Chairman of the House Committee on Ways and Means, introduced H.R. 5095. 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.[448]

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[448] *See* H.R. 5095, 107th Cong., 2d Sess., July 11, 2002, secs. 301-328; *see also* Joint Committee on Taxation, *Technical Explanation of H.R. 5095 (the "American Competitiveness Act of 2002")* (JCX-78-02), July 19, 2002, 55-92.

VIII. OTHER PROVISIONS MODIFYING THE INTERNAL REVENUE CODE

A. Extension of the Puerto Rico Rum Coverover Rate

Present Law

A $13.50 per proof gallon[449] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2003. Effective on January 1, 2004, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon.

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.

Description of Proposal

The proposal extends the $13.25-per-proof-gallon coverover 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 coverover 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 coverover is akin to an entitlement in terms of the annual budget process and making it permanent ensures a steady flow of revenue. Although the coverover 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 coverover rate that could be paid to Puerto Rico and the Virgin Islands in fiscal year 2001.

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[449] A proof of gallon is a liquid gallon consisting of 50 percent alcohol.

B. Deposit Full Amount of Excise Tax Imposed on Gasohol in the Highway Trust Fund

Present Law

Established in 1956, the Highway Trust Fund provides a source of financing for the interstate highway system and provides Federal aid for certain other highway programs. Funds are provided annually to each State Department of Transportation (or its equivalent) to construct and maintain a designated system of roads known as the Federal-aid highway system.[450]

Under present law, gasoline is subject to a tax of 18.4 cents per gallon. In the case of gasoline that is used on the highway, 18.3 cents per gallon of the total tax is paid into the Highway Trust Fund and 0.1 cents per gallon is paid into the Leaking Underground Storage Tank Trust Fund. Gasohol (a blend of alcohol and gasoline) is taxed at a reduced rate, 2.5 cents per gallon of which is retained in the General Fund, 0.1 cents per gallon is paid into the Leaking Underground Storage Tank Trust Fund and the remainder of the reduced rate is deposited in the Highway Trust Fund.

The Code contains a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503 (i.e., not approved by the tax-writing committees of Congress) (sec. 9503(b)(5)). This provision provides that should such unapproved expenditures occur, no further excise tax receipts would be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund.

Description of Proposal

Under the proposal, the 2.5 cents per gallon of the tax imposed on gasohol that is retained in the General Fund is transferred to the Highway Trust Fund. The deposit of 0.1 cent per gallon into the Leaking Underground Storage Tank Trust Fund remains unchanged.

Effective date.–The proposal is effective for collections after September 30, 2003.

Analysis

Generally, the taxes supporting the Highway Trust Fund are on fuels used in vehicles suitable for highway use. Vehicles utilizing gasohol cause the same wear and tear on the highway system as vehicles that do not use gasohol. As a result, proponents argue that the 2.5 cents per gallon of the tax paid by gasohol users should be transferred to the Highway Trust Fund to fund the maintenance of the roads used by such motorists.

Gasohol is taxed at a lower rate to encourage the use of ethanol as a renewable and alternative fuel. Some have argued that retaining 2.5 cents per gallon in the General Fund is a disincentive for States to use ethanol because that money is not made available to the States for

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[450] *See generally*, Congressional Research Service, Report RL31665, *Highway and Transit Program Reauthorization* (December 11, 2002).

highway projects. The Department of Transportation estimates that the highway system requires $56.6 billion annually to maintain the existing road and bridge conditions. Current funding falls short of this goal. Transferring the 2.5 cents per gallon currently retained in the General Fund is estimated to make available to the Highway Trust Fund approximately $400 million annually.

On the other hand, transferring 2.5 cents per gallon out of the General Fund decreases that amount available for other spending priorities. Thus, some might argue that these funds should remain in the General Fund to cover other nonhighway projects.

Prior Action

No prior action.

A similar proposal was included in sec. 2006 of H.R. 4, the "Energy Policy Act of 2002" as passed by the Senate. Bills, entitled "The Highway Trust Fund Recovery Act of 2001" (S. 1306 and H.R. 2808 of the 107th Congress) also proposed to transfer the 2.5 cents per gallon of tax imposed on gasohol to the Highway Trust Fund.

C. 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[451]

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[451] 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.

was eliminated, and all of its powers and responsibilities were transferred to the Treasury IG for 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.[452] The budget also makes conforming changes regarding the disclosure of tax returns and return information to reflect this new, merged office.[453]

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."[454] 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

No prior action.

[452] Appendix, p. 767.

[453] Appendix, p. 807.

[454] Appendix, p. 767.