FY 2007 President's Budget
Tax Initiatives

OVERVIEW

The tax initiatives in the President's budget total $1.757 trillion.

	FY 2006	FY 2007-2016	Total
Tax Cuts	-$16 billion	-$1.741 trillion	-$1.757 trillion

The proposal can be broken into five main components.

Repeal Sunset of 2001 and 2003 Tax Cut. The budget proposes repeal of the sunsets contained in the Economic Growth & Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. Estimated cost: $1.412 trillion over 10 years.

Savings Incentives. The budget includes expanded tax-free saving opportunities, consolidated employer-based savings accounts, and individual development accounts. Estimated cost: $22 billion over 10 years.

Entrepreneurial Investment Incentives. The budget includes a proposal to further expand small business expensing. Estimated cost: $19 billion over ten years.

Health Tax Incentives. The budget includes a modified version of the health care tax incentive proposals that have been included in the budget for the last few years. In particular it would (1) increase the HSA contribution limit to cover all out-of-pocket expenses under the high-deductible policy (current law generally caps the HSA contribution limit at the deductible amount); (2) provide an above-the line deduction and a refundable credit to offset payroll tax obligations for individuals who purchase HSA-eligible coverage; (3) provide a refundable tax credit to low-income individuals who purchase HSA-eligible health insurance; and (4) make technical changes to HSA rules to encourage more employers to offer HSAs to their employees. Estimated cost: $156 billion over 10 years.

Miscellaneous Proposals. Estimated cost: $132.5 billion over 10 years.

1.	Charitables	-$8 billion
2.	Education	-$1.9 billion
3.	Distressed Areas	-$5 billion
4.	Environment	-$1.5 billion
5.	New York City	-$0
6.	Simplification	+$5 billion
7.	Employer-based pensions	-$8.4 billion
8.	Compliance	+$2.3 billion
9.	Tax admin., unemp. ins., and other	+2.1 billion
10.	Energy	+$1.5 billion
11.	Trade	-$11.6 billion
12.	Expiring provisions	-$107 billion

Permanently Extend the 2001 and 2003 Tax Cuts

1. **Marginal Rate Reductions** ($606 billion includes 10-percent bracket)
   The proposal would make permanent the marginal rate reduction included in the 2001 tax bill. The 2001 bill gradually reduced the 39.6%, 36%, 31%, and 28% rates to 35%, 33%, 28%, and 25% by 2006. The 2003 bill accelerated the rate cuts into 2003 and set them to continue through 2010. The proposal would extend the rate cuts beyond 2010. This proposal would also permanently repeal the personal exemption phaseout (PEP) and cutback of itemized deductions (PEASE) scheduled for gradual repeal from 2006 to 2010 (also scheduled to sunset in 2011).

2. **10-percent Rate Bracket**
   The proposal would make permanent the expanded 10-percent bracket. The 2001 bill created a new 10-percent bracket. Effective in 2001, the 10-percent bracket applied to the first $6,000 ($12,000 for couples) in taxable income. This amount was set to increase to $7,000 ($14,000 for couples) in 2008. The 2003 tax bill accelerated the increase in the bracket for 2003 and 2004, and set it to return to the original schedule in 2005. The Working Families bill extended the expanded 10-percent bracket through 2010. The budget extends the $7,000 ($14,000) beyond 2010.

3. **Child Tax Credit** ($168.5 billion)
   The proposal would make permanent the $1,000 child credit through 2010. The 2001 bill increased the child credit from $500 to $1,000 over a period of 10 years. The credit was set to increase to $600 for 2001-2004, $700 for 2005-2008, $800 for 2009, and $1,000 for 2010. The 2003 bill accelerated the $1,000 credit for 2003 and 2004, and set it to return to $700 in 2005. The Working Families Tax Relief Act (the "Working Families" bill) extended the increased $1,000 credit through 2010. The proposal would extend the $1,000 child credit beyond 2010.

4. **Standard Deduction and 15-percent Rate for Married Couples** ($44.9 billion)
   The proposal would make permanent the increase in the standard deduction and 15-percent bracket ("marriage penalty relief") for married couples. The 2001 bill set the standard deduction and the 15-percent bracket for married couples to increase to twice that of single filers. This increase was phased-in over a five year period. The 2003 bill accelerated this relief to 2003 and 2004, but set it to return to the original schedule in 2005. The Working Families bill extended marriage penalty relief through 2010. The proposal would extend the relief beyond 2010.

5. **Education Incentives** ($11 billion)
   The proposal makes permanent the education incentives that were included in the 2001 tax bill with the exception of the above-the-line deduction for tuition and related higher education expenses that expires in 2005.

6. **Estate Tax** ($339.1 billion)
   The proposal would permanently extend the estate tax repeal.

7. **Pension Provisions** ($2.9 billion)
The proposal would permanently extend the pension provisions included in the 2001 bill with the exception of the low and moderate income savers credit that expires in 2006.

8. **Other Incentives for Families** ($4.3 billion)
The proposal would permanently extend the miscellaneous incentives included in the 2001 bill. These include the adoption tax credit, the employer-provided child care credit, and the dependent care tax credit.

9. **Dividends Rate Structure** ($128.1 billion)
The proposal would make permanent the reduced tax rate on dividends permanently. The 2003 tax bill created a new tax rate of 15 percent (5 percent for low-and middle-income taxpayers, going to zero percent in 2008) for dividends. Prior to passage of this bill, dividends were taxed at ordinary income rates. The reduced tax rate is set to expire at the end of 2008. The budget would extend the 15/5 rate structure permanently.

10. **Capital Gains Rate Structure** ($74.9 billion)
The proposal would make permanent the reduced rate on capital gains permanently. The 2003 tax bill reduced the capital gains tax rate from 20 percent (10 percent for low- and middle-income taxpayers) to 15 percent (5 percent for low- and middle-income taxpayers, going to zero percent in 2008). The reduced rate is set to expire at the end of 2008. The budget would extend the 15/5 rate structure permanently.

11. **Small Business Expensing** ($32.6 billion)
The proposal would make permanent the expensing limit (increased from $100,000 to $200,000) for small businesses. The 2003 tax bill increased the amount that small businesses may expense from $25,000 to $100,000, but set the provision to expire at the end of 2005. The American Jobs Creation Act of 2004 (the "JOBS" bill) extended the small business expensing provision through 2007. The budget proposes to increase the limit to $200,000 and index the provision for inflation. The budget would extend the $200,000 permanently.

Encourage Saving

1. **Individual Savings Proposals.** ($122 million)
   The budget proposes two new types of tax preferred savings accounts, described below. The proposal would be effective in 2006.

   - **Retirement Savings Accounts (RSAs).** All types of IRAs (traditional, Roth, and non-deductible) will be replaced with after-tax RSAs. Contribution limits would be $5,000 per year (indexed), and must be out of earned income but with no income limits on those who participate. Distributions after age 58, or in case of death or disability, will be tax-free. Existing traditional and nondeductible IRAs may be converted into RSAs, though there's no requirement that they be converted. Those not converted cannot receive any new contributions (other than rollover contributions). RSAs can be established in conjunction with ERSAs and LSAs.

   - **Lifetime Savings Accounts (LSAs).** The budget proposes the creation of new Lifetime Savings Accounts. LSAs would allow annual contributions of up to $5,000 per year (indexed) of after-tax savings. There are no restrictions on the use of the accounts, nor any limitations on who can establish them. The saver is not required to have earned income. Before January 1, 2007, Coverdell Education Savings Accounts may be converted into LSAs with any tax liability spread over four years. Qualified State Tuition Plans could also be converted if the beneficiary was also the beneficiary on December 31, 2005, subject to a limit on the rollover amount of $50,000 plus 2006 investment earnings and 2006 contributions of up to $5,000. LSAs may be established in conjunction with RSAs and ERSAs.

2. **Employer-Sponsored Savings Plans (ERSAs)** ($20.1 billion)
   All employer-sponsored retirement savings plans (except non-governmental 457 plans) will be consolidated into one new type of account, the Employer Retirement Savings Account (ERSA). Employee contribution limits into ERSAs will follow the current schedule under EGTRRA (start at $14,000 in 2005, rise to $15,000 for 2006 and be indexed for inflation afterwards). A $5,000 catch-up contribution will be available for workers age 50+ starting in 2007. Either after-tax or pre-tax contributions can be made – earnings from after-tax contributions will be tax-free on payout; earnings from pre-tax contributions will be taxable. Non-discrimination rules will be simplified, with a new safe harbor available. One safe harbor would require an employer match of 50% of the first 6% of pay that an employee contributes to the plan each year. The effective date would be January 1, 2007.

3. **Establish Individual Development Accounts (IDA's)** ($1.8 billion)
Creates a new general business credit for institutions that establish and run IDA programs. Individuals between ages 18 and 60 (who are not students) would be eligible to establish IDAs if their incomes are below $40,000 for joint filers ($20,000/singles; $30,000/heads of household). Contributions to the IDAs are not deductible to the taxpayer and any earnings are taxable; matching amounts and earnings on the contributions are not taxable. Withdrawals from the accounts are limited to certain expenses related to higher education, first-time home purchases, and business start-ups unless the beneficiary is over age 61, at which point they can be withdrawn for any purpose. A combination of 2 new tax credits will be available to financial institutions that establish these IDAs for low income individuals: $50 per account each year to offset the cost of establishing and maintaining the account, and providing basic financial literacy training; and a dollar-for-dollar credit for up to $500 contributed to each account annually by the financial institution. The credits are available for the first 900,000 IDA accounts opened after 12/31/06 and before 1/1/12 and with respect to matching funds for participant contributions made for 2008 through 2014.

Encourage Entrepreneurship and Investment

1. Increase Expensing for Small Business ($18.7 billion)
The proposal would expand the expensing provisions of section 179. Specifically, the proposal would increase the maximum amount of qualified property that a taxpayer may deduct under section 179 to $200,000, raise the amount of total qualifying investment at which the phase-out begins to $800,000 per year, and permanently include off-the-shelf computer software as qualifying property. The deduction limit and phase-out threshold would be indexed and the proposal would allow expensing elections to be made or revoked on amended returns. The proposal would be effective for property placed in service in taxable years beginning on or after January 1, 2007.

Health Care

1. Provide an Above-the-line deduction and Income Tax Credit for Purchase of HSA-Eligible Insurance ($41.3 billion)

The proposal would make available an above-the-line deduction (available regardless of whether a taxpayer itemizes deductions) for premiums for high deductible health insurance policies. A high deductible policy is a policy that would qualify the individual to have a Health Savings Account (HSA), but the individual does not have to actually maintain an HSA. The deduction would be available if the individual does not have employer-provided coverage. In addition, individuals covered under a high-deductible policy would be allowed a refundable credit of the smaller of (1) 15.3 percent of the premium, or (2) 15.3 percent of the individual's wages subject to employment taxes. The provision would be effective beginning in 2007.

2. Increase HSA Contribution Limits and Provide a Refundable Income Tax Credit to Offset Employment Taxes on HSA Contributions Not Made by an Employer ($90.1 billion)

The maximum annual HSA contribution limit would be increased to the out-of-pocket limit under the corresponding high-deductible health insurance policy (current law generally caps the HSA contribution limit at the policy's deductible amount). For 2006, the statutory maximum out-of-pocket limit is $5,250 for self-only coverage ($10,500 for family coverage).

3. Provide a Refundable Tax Credit to Lower-Income Individuals for the Purchase of HSA-eligible Health Insurance ($24.1 billion)

Individuals under age 65 would be allowed to claim a refundable income tax credit equal to 90-percent of premiums paid on a high-deductible health insurance policy. The amount of the credit would also be limited by the maximum credit amount per covered family member of $1,000 per adult and $500 per child for up to two children. The maximum credit available to any taxpayer would be $3,000. The maximum credit would begin to be reduced (phase out) at between $15,000 and $25,000 of taxable income, depending on the number of individuals covered by the policy (see table below). In addition, the tax credit could be claimed on the taxpayer's tax return or in advance. Eligibility for the advance credit option would be based on the taxpayer's prior year tax return. Individuals claiming the credit in advance would reduce their premium payment by the amount of the credit, and Treasury would reimburse the health insurer for that amount. Taxpayers would be eligible only if they do not participate in a public or employer-provided health plan. Eligible health insurance plans would be required to meet minimum coverage standards, including coverage for high medical expenses. In addition to private health plans, individuals would be able to purchase insurance through private purchasing groups, state-sponsored insurance purchasing pools, and state high-risk pools. The credit would be effective for taxable years beginning after 2006, but the advance credit would not be available until 2008.

Examples of credit amounts and phase-out points for various taxpayers.

Taxpayer	Maximum Credit	Income at which Credit Begins to be Reduced	Income above which No Credit is Available
Single filer covering 1 adult	$1,000	$15,000	$30,000
2 adults or 1 adult and 1 or more children	$2,000	$25,000	$60,000
2 adults plus 1 or more children	$3,000	$25,000	$60,000

4. Make Other Statutory Changes to Improve HSA Administration ($628 million)

Qualified medical expenses that can be reimbursed by an HSA would be expanded to include premiums for the purchase of non-group HSA-eligible plans. In addition, the reimbursement of the expenses by an HSA established no later than the date for filing the return for that taxable year would be excludable from income. Moreover, employers would be allowed to contribute existing HRA balances to the HSAs of the same employees.

5. **Improve the Health Coverage Tax Credit.** ($190 million)

The proposal would make a number of modifications and improvements to the Health Coverage Tax Credit (HCTC) that was created under the Trade Adjustment Assistance (TAA) Reform Act of 2002. Under current law, the HCTC is a refundable tax credit equal to 65 percent of the cost of qualified health insurance paid by eligible individuals, including certain recipients of TAA benefits and certain individuals between the ages of 55 and 64 who are receiving pension benefits from the Pension Benefit Guaranty Corporation (PBGC). The proposal would modify the HCTC by subjecting State-based HCTC coverage to rules more like HIPAA. The proposal would also permit spouses of HCTC-eligible individuals to claim the HCTC when the HCTC-eligible individual becomes entitled to Medicare coverage if the spouse is age 55. The proposal would also make a number of technical clarifications to the HCTC. The changes would generally be effective in 2007.

6. Allow the Orphan Drug Credit for Certain Pre-designation Expenses (Negligible revenue effect)

Under current law, taxpayers may claim a credit for qualified expenses related to clinical testing of "orphan drugs." Qualified expenses are those incurred after FDA designation. The proposal would permit expenses incurred prior to designation to qualify for the credit.

Charitable

1. **IRA Rollovers** ($4.7 billion)
   The Administrations proposal would allow taxpayers over the age of 65 to directly rollover funds from their IRA to a qualified charitable organization without recognizing any income for tax purposes. Under current law, when a taxpayer withdraws funds from their IRA, these funds are taxable as income, regardless of whether the individual contributes the funds to charity. The effect of this proposal would be to allow a tax free transfer of funds from a taxpayers IRA to the qualified charitable organization of their choice.

2. **Enhanced Charitable Deductions for Contributions of Food Inventory** ($1.3 billion)
   The proposal would enhance allowable charitable deductions of food inventory to qualified charitable organizations. Under current law, taxpayers are generally limited to deducting the basis (cost) of their food inventory when giving it to charity. C-corps may claim an enhanced deduction equal to the lesser of; (1) the taxpayers basis, plus one-half the gain that would have been realized had the food been sold; or (2) two times basis. In addition, the food must be contributed to an organization that; (1) uses the property solely for the purpose of caring for the ill, needy, or infants; (2) does not transfer the food for money; and (3) writes a statement to the donor that they will use food will be used consistent with these requirements. This proposal would allow any taxpayer engaged in a trade or business an enhanced deduction of food inventory equal to the lesser of; (1) fair market value; or (2) two times basis.

3. **Foundation Excise Tax Reform.** ($1.0 billion)
   This proposal would simplify the current two tier rate of foundation excise taxes into a single 1% rate. Under current law qualifying foundations that are exempt from Federal income tax, are subject to a two percent excise tax on their net investment income, but can reduce the amount of that tax where their charitable distributions for the taxable year are greater than their average over the past five. This proposal would eliminate the two tier system and replace it with a single one percent rate. In addition, it would make the tax applicable to a foundation's non-exempt income equal to the sum of the 1% excise tax imposed on investment income and the amount of unrelated business income tax over the income tax imposed on the foundation.

4. **Modify Unrelated Business Income Tax on Charitable Remainder Trusts** ($62 million)
   This proposal would levy a 100% excise tax on unrelated business income from a qualified charitable remainder trust, in exchange for maintaining the trusts tax exempt status. Under current law a charitable remainder trust loses its tax exempt status for the year when they recognize any unrelated business income. This proposal seeks to alleviate the harshness of this rule.

5. **S Corp Modification on Contributions of Appreciated Property** ($301 million)

This proposal allows a S Corp shareholder to increase the basis of the S Corp stock by an amount equal to the excess of the charitable contribution deduction over the shareholders pro rata share. Under current law when S corporations give appreciated property to qualified charities their shareholders are unable to obtain the full benefit of the charitable contribution deduction, this proposal helps correct that.

6. **Repeal the $150 million limitation on qualified 501(c)(3) bonds** ($81 million)

The $150 million limit on the volume of outstanding, non hospital, tax exempt bonds for the benefit of any one 501(c)(3) organization would be repealed. Under current law, the cap only applies to tax exempt bonds of which 95% of proceeds are used to finance capital expenditures after August 5, 1997.

7. **Repeal restrictions on the use of qualified 501(c)(3) bonds for residential rental property.** ($278 million)

In general, under current law tax exempt bonds cannot be issued in any of its proceeds are used to provide residential rental property for family units. Exceptions exist for the financing of certain residential properties that meet tests relating to occupational rates of low income tenants. Under the President's proposal the residential property limitation would be repealed for bonds issued after the day of enactment.

Education

1. **Teacher Deduction for Out of Pocket Classroom Expenses** ($1.9 billion)
   The proposal allows an above-the-line deduction for up to $400 of out-of-pocket expenses incurred by teachers during a taxable year. This is similar to the provision that was enacted in the 2002 tax bill, which expired at the end of 2003. The provision would apply to teachers employed by public entities or private schools at grade levels K through 12. Eligible expenses would include the purchase of books, supplies and equipment related to classroom instruction that become school property, and teacher training expenses related to teaching expenses. The proposal would be effective for expenditures made after Dec 31, 2006.

Provide Assistance to Distressed Areas

1. Establish Opportunity Zones ($4.96 billion)

The proposal is basically a new look at using the tax code to assist rural and urban areas that are suffering economically. The Opportunity Zones builds on previous efforts such as Empowerment Zones and Renewal Communities (both of which expire at the end of 2009) as well as Enterprise Communities (remain in effect through 2004 and many re-designated Empower Zones or Renewal Communities) and New Market Tax Credits.

The proposal allows the Secretary of Commerce to designate 20 opportunity zones – 14 urban and 6 rural – effective for years 2007 through 2016. The criterion for selection is generally, 1) changes in unemployment rates; poverty rates; household income, homeownership and labor force participation; 2) education and average age of population; and 3) for urban areas have their been mass layoffs in last ten years.

The tax benefits include: 1) exclusion of 25 percent of taxable income for certain opportunity zone businesses – business must not exceed $5 million gross receipts average over three-taxable-year period; 2) additional section 179 expensing – an opportunity zone business would be allowed to expense the cost of section 179 property that is qualified zone property up to an additional $100,000 above current section 179. In addition, only 50 percent of the cost of such zone property would count toward the 179 limitation; 3) a commercial revitalization deduction similar to that for renewal communities – limited to $12 million for each zone; 4) wage credit – combined WOTC/welfare to work tax credit.

<u>Protect the Environment</u>

1. **Permanently Extend the Expensing of Brownfield Remediation Costs.** ($1.5 billion)

   The provision that allows the expensing of costs associated with cleaning up hazardous sites ("brownfields") expired on December 31, 2005 and was extended for two years in the Senate Reconciliation Bill to H.R. 4297. The proposal would allow the expensing of these costs permanently. In addition, the Gulf Opportunity Zone Act extended for two years the expensing for qualified contamination sites located within the GO Zone and also permitted the expensing to abate contamination from petroleum within the GO Zone.

Restructure Assistance to New York City

1. **Provide Tax Incentives for Transportation Infrastructure ($2 billion)**
The proposal would provide new tax credits to NY State and NY City for expenditure relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. The tax credit would be allowed in each year from 2007 to 2016, subject to an annual limit of $200 million, and would be divided evenly between the state and the city.

2. **Repeal Certain Liberty Zone Incentives (raises $2 billion)**
The proposal would terminate existing Liberty Zone incentives: (1) the special depreciation allowance for qualified NY Liberty Zone property; (2) the 5-year recovery period for depreciation of qualified Liberty Zone leasehold improvement property; (3) increased section 179 expensing for Liberty Zone property; and (4) the extended replacement period for the nonrecognition of gain for certain involuntary conversions.

Simplifying the Tax Laws for Families

1. **Clarify uniform definition of a child.** (+$2.6 billion)
   The Working Families bill provided a uniform definition of a child for the dependent care exemption, head of household filing status, the child tax credit, the child and dependent care tax credit and the EITC. The Treasury Department believes the Working Families bill made unintended changes to the sibling eligibility requirements for child-related tax benefits. To correct these problems, the proposal stipulates that a taxpayer cannot be the qualifying child of another individual, if the taxpayer is older than that individual except in certain cases where the taxpayer is permanently and totally disabled. Parents residing with qualifying children for more than half the year would preclude others from claiming the child. However, the proposal permits the parent to waive the child-related benefits to another member of the household who has higher AGI and would otherwise qualify**.**

2. **Simplify EITC eligibility requirement regarding filing status, presence of children, and work and immigration status.** ($894 million)
   The proposal seeks to simplify the determination of EITC eligibility by allowing separated spouses, regardless of filing status, to claim the EITC if they live with a qualifying child for over half the year. The proposal also would allow taxpayers who have a qualifying child (other than unmarried parents who reside together with their child) to claim the EITC for workers without a qualifying child if somebody else claims that child as a qualifying child or if the child does not have a valid social security number. Finally, the proposal seeks to have the Treasury Department and the IRS develop an outreach strategy to ensure that taxpayers, including those whose immigration and work status has changed since they received social security numbers, are aware of the EITC social security number requirements.

3. **Reduce computational complexity of refundable child tax credit.** (+$3.3 billion) Under the proposal the additional child tax credit for taxpayers with three or more children would be based solely on the formula that uses earned income, regardless of the number of children in a taxpayer's family (the alternative formula would no longer be allowed). The definition of earned income for purposes of the additional child tax credit would be conformed to that currently used for the EITC and would therefore be determined without regard to whether or not that income is included in taxable income. Finally, the proposal would require taxpayers to reside with a child in the United States to claim the additional child tax credit (the principal place of abode for members of the U.S. Armed Forces would be treated as in the U.S. for any period the member is stationed outside the U.S. while serving on extended active duty).

Employer-based pensions

1. **Ensure fair treatment of older workers in cash balance conversions and protect defined benefit plans** (Raises $1.0 billion)
   Traditional defined benefit plans promise a participant a certain monthly income at retirement age, usually based on years of service and compensation. A defined contribution plan, such as a 401(k) plan, has individual accounts that are credited with contributions and investment return. The benefit paid from a defined contribution plan is the accumulated account balance. A cash balance plan is a defined benefit pension plan with a benefit structure that looks like a defined contribution plan. The cash balance benefit an employee has earned is defined in terms of an "account balance." Under a cash balance plan, the employer credits an employee's "account" with a fixed percentage of the employee's pay and interest on the account balance. Unlike a defined contribution plan, however, the account balances are merely hypothetical bookkeeping devices. Plan assets are commingled. The amount of interest credited to the accounts is based on an index, such as the 1-year Treasury rate plus 2%, instead of actual investment return.

   One recent court case declared cash balance plans discriminatory under the law. Other court cases have ruled against companies on issues relating to interest credits, and the methodology for converting a traditional defined benefit plan to a cash balance plan. These court cases have left employers looking for guidance. The Treasury appropriations bill included in the Omnibus bill passed in January 2004 included a provision prohibiting Treasury from drafting regulations, and directing Treasury to recommend legislation on cash balance plans. The proposal would provide transition rules for converting traditional defined benefit plans to cash balance plans, clarify that cash balance plans are not necessarily discriminatory, and remove the ceiling on interest credits that resulted from court cases and previously issued guidance.

2. **Strengthen Funding for Single-Employer Pension Plans** ($ 9.2 billion)
   The proposal would make significant changes to the rules governing defined benefit pension plans. The changes are extensive, affecting minimum funding, deductible contributions, benefit accruals and payments, reporting and disclosure, and insurance premiums payable to the Pension Benefit Guaranty Corporation (PBGC). The proposal includes, in somewhat revised form, the basic elements of the 2005 budget proposal including use of the yield curve to measure liabilities, increased disclosure to participants and the government, and benefit limitations on plans that are underfunded. Phase in of the yield curve for funding purposes would begin with plan years beginning in 2006. The phase in would be at the rate of one-third per year and be fully phased in for the first plan year beginning in 2008. The corporate bond rate in effect for 2005 would serve as the base during the phase in period. The purpose of the yield curve is to provide more accurate measurement of the liability for benefits already earned under these plans.

The most significant change ties both the funding and premium requirements to the financial health of the employer through the employer's bond ratings. A company whose bond rating was below investment grade (i.e., junk) would have to determine its liability by assuming employees would retire earlier than if the employer were healthy. The result would be higher projected utilization of subsidized benefits and thus higher liabilities for companies rated below investment grade than for investment-grade companies. An employer that moved from investment grade to junk would transition to the higher liabilities over five years. The result would be higher contribution requirements and higher PBGC variable premiums for financially troubled companies. Plans of companies that are junk rated would be subject to restrictions on benefits increases, accruals and lump sum payments if funding falls below specified levels. Plant shutdown benefits would be prohibited.

3. Reflect Market Interest Rates in Lump Sum Payments (raises $274 million)

The yield curve proposed for funding of defined benefit plans would be phased in for purposes of calculating lump sum distributions from defined benefit plans. The phase in would begin with plan years beginning in 2008. The phase in would be at the rate of one-third per year, and be completed by the first plan year beginning in 2010. The 30-year Treasury rate currently used to determine lump sum payments would serve as the base during the phase in period.

Compliance

1. Combat Abusive Foreign Tax Credit Transactions (+26 million)

Supplemental regulatory authority would be granted to the Treasury Department to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income. The regulations could provide for either a disallowance of a credit, or an allocation of foreign taxes among participants in a manner more consistent with the underlying economics of the transaction. The proposal generally would be effective after enactment. The proposal is identical to last year's budget proposal, except that it is described as regulatory authority that is supplemental to broad existing authority, rather than additional regulatory authority. This provision was included in the Senate-passed JOBS Act, but was not agreed to in conference, and is included in the Senate-passed Tax Relief Extension Reconciliation Act.

2. Modify the Active Trade or Business Test. (+$89 million)

A corporation generally is required to recognize gain on the disposition of property (including stock of a subsidiary) to its shareholders as if the corporation had sold the property for fair market value. Shareholders receiving the distributed property are ordinarily treated as receiving a dividend equal to the value of the distribution (to the extent of the corporation's earnings and profits) or capital gains. An exception to these rules applies if a corporation satisfies the requirements of section 355. Section 355 allows corporations to spin-off or split-off their current operations on a tax-free basis. Section 355 requires that both the distributing corporation and the "distributed" controlled corporation must immediately after the distribution be engaged in the active conduct of a trade or business which has been conducted for at least 5 years and was not acquired in a taxable transaction during that 5 year period. The Administration has determined that some transactions that satisfy this rule resemble cash redemptions and, therefore, should not receive tax-free treatment. These transactions (so-called "cash-rich splits") involve a non-pro rata distribution in which a corporate shareholder of a distributing corporation receives stock of a controlled corporation which holds primarily investment assets. The proposal would require that in the case of a non-pro rata distribution, at least 50 percent of a corporation's assets must be used, or held for use, in an active trade of business. The proposal is identical to last year's budget proposal, and is a more targeted version of an analogous proposal in the Joint Committee on Taxation Report JCS-02-05, "Options to Improve Tax Compliance and Reform Tax Expenditures." An analogous, but narrower, version of this proposal is included in the Senate-passed Tax Relief Extension Reconciliation Act.

3. Impose Penalties on Charities That Fail to Enforce Conservation Easements (raises $91 million)

There is a problem of donations of facade easements and land easements that are then modified without notification to the IRS or are not properly enforced by the charity. The administration proposal would impose penalties on any charity that removes or fails to enforce a conservation restriction for which a charitable contribution deduction was claimed, or transfers such an easement without ensuring that the conservation purposes will be protected in perpetuity.

4. Eliminate the special exclusion from unrelated business taxable income for gain or loss on the sale or exchange of certain brownfield properties. (+201 million)

The American Jobs Creation Act of 2004 created a special exclusion from unrelated business taxable income of gain or loss from the sale or exchange of certain brownfield properties acquired by a tax-exempt organization between January 1, 2005 and December 31, 2009. Treasury believes the proposal adds considerable complexity and would be difficult to administer. In addition, Treasury has concerns about the effectiveness of the new provision because there is no limit on the amount of gain that is exempt from UBIT and believes the provision has the potential to exempt from income real estate development activities beyond the scope of environmental remediation. The proposal would eliminate the special exclusion effective for taxable years beginning after December 31, 2006.

5. **Limit Related Party Interest Deduction.** (+$1,635 million)

Section 163(j) would be revised to tighten the limitation on the deductibility of interest paid to foreign related persons. The current law 1.5 to 1 debt-to-equity safe harbor would be eliminated. The adjusted taxable income threshold for the limitation would be reduced from 50 percent to 25 percent of adjusted taxable income with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee (hereinafter referred to as "guaranteed debt"). Interest on guaranteed debt generally would be subject to the current law 50 percent of adjusted taxable income threshold. The indefinite carryforward for disallowed interest under the adjusted taxable income limitation of current law would be limited to ten years. The 3-year carryforward of excess limitation would be eliminated. This is identical to last year's budget proposal, but it may change depending on the outcome of Treasury's pending earnings stripping study, which was requested by Congress in the AJCA '04. The report was due June 30, 2005, but has not yet been completed. The proposal would be effective on the date of first committee action.

6. Clarify and Simplify Qualified Tuition Programs ($222 million in revenue)

The proposal limits each section 529 account to only one contributor, but would allow others to contribute to the account in *de minimis* amounts. The contributor would be able to name an account administrator who would be permitted to change the designated beneficiary (DB). The account administrator would have no interest in the account. In addition, the proposal imposes a new excise tax payable from the account if: (i) a nonqualified distribution is made to a DB who is neither the account's contributor nor the initial DB of the account; (ii) the total amount of nonqualified distribution exceeds $50,000 (computed on a cumulative, lifetime basis for each DB); and (iii) the nonqualified distribution is not made as a result of the DB's disability, receipt of a scholarship, or attendance at a U.S. military academy. The excise tax would be imposed at the rate of 35% on the first $100,000 of cumulative nonqualified distributions in excess of $50,000, and at the rate of 50% on any amount of cumulative nonqualified distributions in excess of $150,000. Upon a DB's death, the account would be distributed to the DB's estate unless, within a stated period of time after the DB's death, either the contributor withdraws the funds from the account, or the account administrator names a new DB. The DB's gross estate would include only amounts (if any) paid to the DB's estate or pursuant to the DB's general power of appointment. To preserve the ability to verify the contributor, initial DB, and date of creation of each section 529 account, only direct trustee to trustee rollovers would be permitted. Additional rules would prevent transfers for consideration of interests in section 529 accounts. The rules applicable to trusts contributing to section 520 accounts would be clarified. Special rules would apply to implement the purposes of the provision when a contributor is the initial DB of an account and when a contributor does not name another person as account administrator. Special rules also would apply to a series of changes in the DB of an account followed by a distribution to the initial DB. The Secretary would be granted broad regulatory authority to ensure that section 529 accounts are used in a manner consistent with congressional intent. The proposal generally would be effective for section 529 accounts (including prepaid tuition contracts) established after the date of enactment. Additional contributions to existing section 529 savings accounts would be prohibited unless those accounts elect to be governed by the new rules. Any modified reporting requirements would apply after the date of enactment to all section 529 accounts.

<u>Improve Tax Administration</u>

1. **Make Section 1203 of the IRS Restructuring and Reform Act of 1998 More Effective and Fair.** (No Revenue Effect)
   The proposal would modify the Act by removing both the late-filing of refund returns and employee vs. employee acts from the list of violations, while adding the unauthorized inspection of returns or return information to the list. It also requires the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific wrongful conduct.

2. **Curb the Use of Frivolous Submissions and Filings Made to Impede or Delay Tax Administration.** (No Revenue Effect)
   The proposal would increase the penalty for frivolous tax returns from $500 to $5,000, while also allowing the IRS to dismiss requests for collection due process hearings and other procedures if they are based on frivolous arguments or meant to impede tax administration. The proposal also gives the IRS greater ability to maintain records of frivolous submissions by taxpayers but would be required to remove designations after a reasonable period of time.

3. **Allow for the Termination of Installment Agreements for Failure to File Returns and for Failure to Make Tax Deposits.** (No Revenue Effect)
   The proposal would allow the IRS to terminate an installment agreement if a taxpayer fails to file tax returns or make required federal tax deposits in a timely fashion.

4. **Consolidate Judicial Review of Collection Due Process Cases in the United States Tax Court. (**No Revenue Effect**)**
   The proposal would provide that the US Tax Court shall be the exclusive venue for suits to obtain judicial review of any determination issued by Appeals after a collection due process hearing.

5. **Eliminate the Monetary Threshold for Counsel Review of Offers in Compromise.** (No Revenue Effect)
   The proposal would eliminate the requirement that the opinion of Chief Counsel be filed for any compromise involving unpaid tax, penalty, or interest equal to or exceeding $50,000. The Secretary would instead establish standards for when the opinion of the Counsel must be obtained.

6. **Allow the Financial Management Service to Retain Transaction Fees from Levied Amounts. (**No Revenue Effect**)**
   The proposal would allow Financial Management Service (FMS) to retain directly a portion of the levied funds as payment for FMS's fees [rather than use of IRS appropriated funds]. A delinquent taxpayer, however, would receive full credit for the amount levied upon. The proposal alters internal government accounting.

7. **Expand authority to require electronic filing by large businesses and exempt organizations** (No Revenue Effect)

The proposal would incrementally expand the Secretary's authority to require businesses and exempt organizations to file their returns electronically. It lowers the current 250-return minimum for mandatory electronic filing, but would maintain the minimum at a high enough level to avoid imposing an undue burden on taxpayers. Under the proposal, taxpayers that fail to file their returns electronically when required would be subject to a monetary penalty.

8. **Allow IRS to access information in the National Directory of New Hires for tax administration purposes.** (No Revenue Effect)

The Office of Child Support Enforcement of the Department of Health and Human Services (HHS) maintains the National Directory of New Hires (NDNH), which is a database that contains (i) newly-hired employee data from Form W-4; (ii) quarterly wage data from state and federal employment security agencies; and (iii) unemployment benefit data from state unemployment insurance agencies. The NDNH was created to help state child support enforcement agencies enforce obligations of parents across state lines. The IRS may obtain data from the NDNH, but only for administration of the EITC. This provision would allow the IRS access to the database for general tax administration. Data obtained by the IRS would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

9. **Extend IRS Authority to fund undercover operations.** (No Revenue Effect)

Extends IRS authority to use proceeds received from undercover operations through December 31, 2011. It recently was extended through December 31, 2006 in the Katrina bill.

10. **Implement Standards Clarifying When Employee Leasing Companies are Liable for Clients' Employment Taxes**. (+$57 million)

The proposal would set standards to determine when employee leasing companies are liable for employment taxes and when the client is liable for the taxes. No specific standards are included in the proposal.

11. **Increased Information Reporting on Payment Card Transactions (e.g.,Credit Cards)** (+$225 million)

Gives the Secretary authority to issue regulations to require credit card and other payment card companies to report to IRS annually the amount of payments to a vendor. If the vendor fails to provide the payment card company with a TIN, back-up withholding would apply.

12. **Require Increased Information Reporting for Certain Government Payments for Goods and Services.** (+$2 billion)

Authorizes the Secretary to issue regulations requiring information and back-up withholding on all non-wage payments by Federal, state and local governments for property and services.

13. Amend Collection Due Process Procedures for Employment Tax Liabilities. (+$364 million)

Authorizes IRS to levy employment taxes *before a* Collection Due Process hearing is held (taxpayer has a right to a CDP hearing within a reasonable time after the levy). Under current law, employers can request a CDP before collection, and all collection by levy is suspended until the proceeding is concluded.

14. **Expand the Signature Requirement and Penalty Provisions Applicable to Paid Tax Return Preparers**. (+$914 million)

Expands preparer identification and penalties to non-income tax returns and non-income tax return related documents prepared for compensation. Under current law, only income tax returns and income tax return related documents are covered.

15. Strengthen the Financial Integrity of the Unemployment Insurance System by Reducing Improper Benefit Payments and Tax Avoidance (cost $2.246 billion)

The proposal would allow states to redirect up to 5 percent of unemployment insurance overpayment recoveries to additional enforcement activity. The proposal requires states to impose a 15 percent penalty on recipients of fraudulent overpayments; the penalty would be used exclusively for additional enforcement activity. States would also be required to take unemployment insurance overpayments resulting from employer fault into account for purposes of the employer's experience rating account, even if the overpayment is later recovered. States would be allowed to permit private collection agencies to retain a portion of such unemployment insurance overpayments or delinquent taxes collected. The proposal allows the Secretary of the Treasury to reduce any federal income tax refund owed to a benefit recipient when that recipient owes a benefit overpayment to the state.

Modify Energy Policy Act of 2005

1. **Repeal Reduced Recovery Period for Natural Gas Distribution Lines** (+$833 million).

 The proposal would repeal the 15 year class life from the Energy Policy Act of 2005 and would assign natural gas distribution lines a 20 year recovery for purposes of MACRS and maintain a 35-year class life for purposes of the alternative depreciation system, effective for lines placed in service after December 31, 2006. The change from the Energy Policy Act is because the Act's change to 15 years benefits gas utilities rather than gas producers, and it does not significantly add to the nation's energy supplies over what a 20 year recovery would provide.

2. **Modify Amortization for Certain Geological and Geophysical Expenditure.** (+$730 million).

The proposal would repeal two year amortization provided by the Energy Policy Act of 2005 and would establish a five-year amortization period for geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States. The five year period would apply even if the property is abandoned. The proposal would be effective for taxable years beginning after December 31, 2006.

Expiring Provisions

1. **Minimum Tax Relief for Individuals ($20.5 billion)**
The proposal would continue higher AMT exemption levels ($40,250 single, $58,000 married filing jointly, and $29,000 married filing separately) through 2006. In addition, the proposal would allow an individual to reduce 2006 tax liability by the full amount of nonrefundable personal credits even if tax liability is reduced to an amount that is less than the individual's tentative minimum tax. This provision costs $20.5 billion over 10 years for this one-year proposal (score does not include $13.6 billion cost in 2006).

2. **Permanently Extend Research and Experimentation (R&E) Tax Credit ($86.4 billion)**
The research and experimentation (R&E) tax credit is 20 percent of qualified research expenses above a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The taxpayer's fixed base percentage generally is the ratio of its research expenses to gross receipts for the 1984-88 period. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year. Taxpayers can elect into a three-tiered alternative credit that has lower credit rates (ranging from 2.65 to 3.75 percent) and lower statutory fixed base percentages (ranging from 1 to 2 percent). The R&E credit is scheduled to expire on December 31, 2005. This provision would make it permanent, but without the modifications to the alternative incremental research credit and the addition of the alternative simplified credit as proposed in Hatch/Baucus legislation.

3. **Permanently Extend and Expand Disclosure of Tax Return Information for Administration of Student Loans (No Revenue Effect)**
The proposal would permit the IRS to disclose to the Department of Education and its contractors identity information, filing status, adjusted gross income, earnings from employment, income tax liability, and type of tax return filed for purposes of verifying student financial aid applications, as well as establishing repayment amounts. The Department of Education and its contractors would remain subject to confidentiality restrictions and safeguards with respect to return information. The legislation would help to reduce fraud and error in student financial aid programs.

4. **Extend and Modify WOTC/Welfare-to-work tax credit. ($266 million)**
The proposal would simplify the employment incentives by combining the credits into one credit and making the rules for computing the combined credit simpler. The credits would be combined by creating a new welfare-to-work target group under the work opportunity tax credit. The minimum employment periods and credit rates for the first year of employment under the present work opportunity tax credit would apply to welfare-to-work employees. The maximum amount of eligible wages would continue to be $10,000 for welfare-to-work employees and generally $6,000 for other target groups ($3,000 for summer youth). In addition, the second-year 50-percent credit currently available under the welfare-to-work credit would continue to be

available for welfare-to-work employees under the modified work opportunity tax credit. Qualified wages would be limited to cash wages. The work opportunity tax credit would also be simplified by eliminating the need to determine family income for ex-felons. The modified work opportunity tax credit would apply to individuals who begin work after December 31, 2005, and before January 1, 2007.

5. Extend the First-Time Homebuyer Credit for the District of Columbia ($18 million)

A one-time, non-refundable $5,000 credit is available to purchasers of a principal residence in the District of Columbia who have not owned a residence in the District during the year preceding the purchase. The credit phases out for taxpayers with modified adjusted gross income between $70,000 and $90,000 ($110,000 and $130,000 for joint returns). The credit does not apply to purchases after December 31, 2005. The first-time homebuyer credit for the District of Columbia would be extended for one year, making the credit available with respect to purchases through December 31, 2006.

6. Extend Authority to Issue Qualified Zone Academy Bonds ($179 million)

Aging school buildings and new educational technologies create a need to renovate older school buildings and to develop new curricula. Many school systems have insufficient fiscal capacity to finance needed renovation and programs. The QZAB provision encourages the development of innovative school programs through public/private partnerships. A reporting requirement would facilitate evaluation of this provision and assist in its administration by the IRS. The authority to issue $400 million of QZABs per year would be extended for one year to 2006. For QZABs issued after date of enactment, issuers would be required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

7. Extend Provisions Permitting Disclosure of Return Information Relating to Terrorism (No Revenue Effect)

Current law permits disclosure by the IRS of return information to aid the investigation or response to terrorism in two situations. First, if a specified official of a federal law enforcement or intelligence agency submits a written request, the IRS may disclose a taxpayer's identity and return information to such agency's officers and employees involved with a terrorist incident, threat, or activity. The head of a federal law enforcement agency in turn may make disclosures to State or local law enforcement agencies working as part of a team on the investigation or response. Second, if the IRS wishes to apprise a federal law enforcement agency of a terrorist incident, threat, or activity, the IRS may disclose a taxpayer's identity and return information to the agency's head (who in turn may disclose the information to agency officers and employees as necessary). The proposal extends this authority until December 31, 2006.

9. Extend Excise Tax on Coal at Current Rates (+$750 million)

The proposal would retain the excise tax on coal at the current rates until the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the general fund of the Treasury. After repayment of the Fund's debt, the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines would apply and the tax per ton of coal would be capped at 2 percent of the amount for which it is sold by the producer. The proposal would be effective for coal sales after December 31, 2005.

10. Include Combat Pay as Earned Income for the Earned Income Tax Credit (Revenue Effect Not Listed)

Generally, compensation earned by members of the Armed Forces while serving in combat zones may be excluded from gross income; nontaxable compensation is not includable in earned income for purposes of computing the Earned Income Tax Credit (EITC). A taxpayer may elect to treat combat pay otherwise excluded as earned income for EITC purposes, effective for taxable years ending after October 4, 2004 and before January 1, 2007. Excluding combat pay from earned income can decrease or increase the amount of the EITC received by military personnel serving in combat zones. The effect of the exclusion varies depending on several factors, including rank, number of months in a combat zone and number of children. The proposal would extend the availability of the election through December 31, 2007 to include combat pay as earned income for purposes of the EITC and assist low-ranking enlisted personnel who serve long periods in combat zones.