Order Code RL32719

CRS Report for Congress
Received through the CRS Web

Major Tax Issues in the 109th Congress

January 5, 2005

David L. Brumbaugh
Specialist in Public Finance
Government and Finance Division

Major Tax Issues in the 109th Congress

Summary

The 108th Congress considered a variety of tax issues over the course of 2004. Some of these were relatively narrow, applying to particular sectors or activities; examples included energy taxation, charitable giving and charities, Internet taxation, tax shelters, and a variety of expiring tax benefits that apply to particular investments or activities. More prominent, however, were two more general issues that were the focus of tax policy deliberations for much of the year: domestic and international business taxation; and the extension of tax cuts for individuals that were initially enacted in 2001 and 2003.

Congressional deliberations on business taxation grew out of a long-simmering controversy between the United States and the European Union (EU) over the U.S. extraterritorial income exclusion (ETI) tax benefit for exporting. The EU had lodged complaints with the World Trade Organization (WTO) maintaining that the ETI benefit and several predecessors in the U.S. tax code violated the WTO's strictures against export subsidies. In late spring, 2004, both the House and Senate passed legislation phasing out ETI. However, the bills in each chamber extended far beyond the ETI issue to include a wide variety of tax benefits for domestic and international investments as well as revenue-raising provisions in areas such as corporate tax shelters and leasing transactions. In October, Congress approved a conference committee version of the legislation, which became the American Jobs Creation Act (P.L. 108-357).

The tax cuts Congress enacted in 2001 with the Economic Growth and Tax Relief Recovery Act (EGTRRA; P.L. 107-16) were a gradual phase-in of a variety of provisions, including reduction of individual income tax rates and tax cuts for married couples and families. In 2003, the Jobs and Growth Tax Relief Reconciliation Act's (JGTRRA; P.L. 108-27) principal thrust was to move the effective date of EGTRRA's gradual tax cuts forward to 2003. However, several of JGTRRA's accelerations were scheduled to expire at the end of 2004, including an increase in the child tax credit, tax cuts for married couples, and reduction of the alternative minimum tax. In September, Congress approved the Working Families Tax Relief Act (WFTRA; P.L. 108-311), which generally extended JGTRRA's tax cuts as well as a set of other temporary tax benefits.

Early indications suggest several tax issues may receive congressional attention in 2005. One possibility is fundamental tax reform: the Administration has stated that consideration of tax reform is one of its top domestic priorities for 2005 and the topic has received considerable congressional interest in the past. Another possible issue may be the alternative minimum tax, which, absent modifications, will apply to an increasing number of taxpayers. And, notwithstanding the tax cut extensions enacted under WFTRA in 2004, the tax cuts enacted under EGTRRA in 2001 are scheduled to expire at the end of 2010. Congress may consider legislation to extend or make permanent the 2001 cuts.

This report will be updated as tax-related legislative activity occurs and its economic setting changes.

Contents

The Economic Context 1
The State of the Economy 2
The Federal Budget 3
The Federal Tax Burden 4

Possible Tax Issues in 2005 5
Scheduled Expiration of Enacted Tax Cuts 5
The Alternative Minimum Tax for Individuals 7
Tax Reform 8

Major Tax Legislation, 2001-2004 10
The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) 10
Job Creation and Worker Assistance Act of 2002 (JCWA; P.L. 107-147) 12
The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) 12
Working Families Tax Relief Act of 2004 (H.R. 1308; P.L. 108-311) 14
The American Jobs Creation Act (H.R. 4520; P.L. 108-357) 15

Major Tax Issues in the 109th Congress

The 108th Congress considered a variety of tax issues over the course of 2004. Some of these were relatively narrow, applying to particular sectors or activities; examples included energy taxation, charitable giving and charities, internet taxation, tax shelters, and a variety of expiring tax benefits that apply on particular investments or activities. More prominent, however, were two more general issues that were the focus of tax policy deliberations for much of the year: domestic and international business taxation; and the extension of tax cuts for individuals that were initially enacted in 2001 and 2003. Congressional action on these topics culminated in enactment of the Working Families Tax Relief Act (P.L. 108-311), which focused on tax-cut extensions, and the American Jobs Creation Act (P.L. 108-357), an omnibus business tax bill.

Early indications suggest a number of possible topics may be the focus of congressional tax policy deliberations in 2005. One prominent possibility is fundamental tax reform — the Administration has indicated that consideration of a basic restructuring of the tax system is one of its chief domestic policy priorities for its second term. Other possibilities for congressional attention are revision of the alternative minimum tax and extension of tax cuts that are scheduled to expire. Each of these topics is discussed in more detail below. (See the section entitled "Possible Tax Issues.") First, however, it is useful to briefly review the economic context in which the issues may be considered.

The Economic Context

Tax policy is frequently considered by policymakers as a tool for boosting economic performance in various ways, and the likely economic effects of tax policy are often hotly debated. For example, if the economy is sluggish and unemployment is high, tax cuts are sometimes recommended by some as a fiscal stimulus to boost demand. Or, in the longer term, tax cuts for saving and investment are championed by some as a means of boosting long-term economic growth. At the same time, taxes can also affect long-run growth through the federal budget — along with spending, tax revenues determine the size of the budget surplus or deficit. And the size and nature of the budget balance can affect long-run growth by determining the extent to which government borrowing needs compete for capital with private investment, thus damping long-run growth.

As well as affecting economic performance — both in the short- and long-runs — taxes have a distributional effect. That is, the rate and manner in which taxes apply to different activities, groups, and income levels can alter the distribution of income within the economy. For example, the taxes can affect the distribution of income across income levels (can affect "vertical equity") by applying at different

rates to different income levels. And taxes can affect "horizontal equity" by applying differently to different types of income.

With these broad economic effects in mind, a discussion of three aspects of the economy follows. First is a look at the current state of the economy, both in terms of long-run growth and the short-run state of the business cycle. Next is a review of the current, recent, and expected future state of the federal budget. Third is a brief review of the level and distribution of the tax burden.

The State of the Economy.

Over the first three quarters of 2004, the economy continued its expansion and recovery from the recession that reached its trough in November, 2001; the economy has now registered positive real economic growth for 12 consecutive quarters. Real growth was relatively sluggish during the first quarters of the recovery, but began to pick up momentum in mid-2003. Real gross domestic product (GDP) grew at 4.5% in the first quarter of 2004, 3.3% in the second quarter, and 3.9% in the third quarter. The favorable economic performance is qualified, however, by relatively slow growth in employment (leading some to characterize the current situation as a "jobless recovery"), but most prognosticators expect economic growth to continue into 2005.

Although the current economic context of tax policy is thus one of growth, one principal focus of the tax policy debate in recent years has been the efficacy of tax cuts as an economic stimulus. The tax cuts of 2001, 2002, and 2003 were enacted, in part, as a means of stimulating a still-sluggish economy, and although the recession has ended and economic growth has picked up momentum, the debate over the merits of tax cuts as economic stimulus continues to resonate. For example, one subject of current debate is the extent to which tax cuts are responsible for the economy's rebound and the extent to which factors such as monetary policy are responsible. It is thus informative to review the main outlines of economic performance over the past few years.

The economic boom of the 1990s lasted nine consecutive years, but by late 2000, the economy began to show signs of weakness. President-elect Bush had called for a tax cut during the election campaign for philosophical reasons and to spur long-term growth, but as 2000 came to an end, he added that a tax cut would now also be advisable as a means of providing a near-term fiscal stimulus to the sluggish economy. The tax cut he proposed in January 2001 ultimately became the basis for the large reduction enacted as EGTRRA in June 2001.

As 2001 progressed, there were increasing signs of economic weakness, and in November, the National Bureau of Economic Research (NBER; the organization that tracks business cycles) determined that a recession had begun in March of that year. Economic data now show that the economy contracted during the first three quarters of 2001 before registering positive growth again in the fourth quarter of that year. The recession ended in November 2001, having lasted eight months. The recession

was of about average severity and duration for economic recessions of the post-World War II era.[1]

Following the recession, the economy registered positive growth in all four quarters of 2002, but still exhibited signs of sluggishness. Business investment spending was weak and employment continued to decline through 2002. Further, the pattern of growth was uneven, leading observers to characterize the economy's performance since the end of the recession as "choppy" and "sub-par." Several factors were thought to be placing a drag on the economy: a long adjustment in capital spending; the "fallout" from revelations of corporate malfeasance; declines in the stock market; and increased "geopolitical risks," including the possibility of war in Iraq.

Positive economic growth continued through all four quarters of 2003 and accelerated. As noted above, growth has continued into 2004, although it registered (in the words of Federal Reserve Chairman Greenspan) a "soft spot" of slightly slower growth in late Spring — the likely result of rising energy costs. Another qualification is sluggish employment growth. Payroll employment in 2004 has remained below the peak it registered before the 2001 recession. The unemployment rate in 2004 has fluctuated between 5.4% and 5.7%, and has remained at a generally higher level than those registered during the boom of the 1990s.

For further reading, see CRS Report RL30329, *Current Economic Conditions and Selected Forecasts,* by Gail Makinen.

The Federal Budget.

In its November 2004 *Monthly Budget Review*, the Congressional Budget Office (CBO) reported that the federal budget registered a deficit in FY2003 amounting to 3.5% of GDP and a deficit equal to 3.6% of GDP in FY2004. The deficit in FY2004 marked the third year in a row the budget has registered a deficit, with the size of the deficit growing in each successive year. CBO's September update on the budget and economic outlook, however, projected a gradual decline in the deficit as percentage of GDP beginning with FY2005, shrinking to a position of near-balance (a deficit of 0.4% of GDP) by 2012. As described below, however, this projection assumes that current policies remain in place, and if that assumption is dropped, the outlook changes — an important consideration given congressional interest in extending or making permanent the 2001 and 2003 tax cuts.

A broader historical perspective shows several reversals in the federal budget situation in recent years. The budget was in deficit throughout the 1970s, 1980s, and most of the 1990s before registering a surplus in FY1998, a result of both the booming economy and legislation designed to enforce budget discipline. The budget surplus grew for the next two years, reaching a peak of 2.4% of GDP in FY2000 before declining in FY2001 and moving into deficit in FY2002 and FY2003. The difference between the surplus in FY2000 and the deficit in FY2004 amounted to

---

[1] CRS Report RL31237, *The 2001 Economic Recession: How Long, How Deep, and How Different from the Past?,* by Marc Labonte and Gail Makinen, p. 29.

6.0% of GDP. The budget data indicate that the change was a result of both a growth in outlays and a decline in revenues. The decline in revenues was more pronounced, however; revenues declined from 20.6% of GDP in FY2000 to 16.4% in FY2004, a drop of 4.2 percentage points. Outlays increased by only 1.8 percentage points over the same period. The decline in revenues has two sources: the recession of 2001 and subsequent sluggish economic growth, and enacted tax cuts.

The outlook, however, may change. As described elsewhere in this report, the tax cuts enacted in 2001 by EGTRRA expire at the end of calendar year 2010; parts of JGTRRA's acceleration of EGTRRA (as extended by legislation in 2004) expire at various times before 2010. Extending the tax cuts would have a substantial impact on the budget, particularly after 2010. In addition, the application of the alternative minimum tax (AMT) to an increasing number of taxpayers may exert pressure to increase the AMT's exemption amount. In September, 2004, CBO estimated the impact extending EGTRRA and JGTRRA's tax cuts (including an increased AMT exemption) would have on receipts and the budget deficit. The estimates indicate that the extension would reduce revenues by $350 billion in FY2012, the first full fiscal year after EGTRRA's expiration. This amounts to 10.6% of revenues that are otherwise estimated to occur.

The longer-term budget situation is a concern to many policymakers, chiefly because of the combination of rising health care costs and demographic pressures posed by an aging population that will begin with the retirement of the "baby boom" generation. Under current law, spending on Social Security, Medicare, and Medicaid is expected to increase substantially as a share of the economy. The Congressional Budget Office has estimated that combined spending on the three programs will grow from 8% of GDP in 2004 to over 14% in 2030 and to almost 18% by 2050.[2] According to CBO, either substantial increases in taxes or cuts in spending will likely be necessary in the future if fiscal stability is to be maintained.[3]

For additional information, see CRS Report RL31784, *The Budget for Fiscal Year 2004*, by Philip D. Winters, CRS Report RL31778, *The Size and Scope of Government: Past, Present, and Projected Government Revenues and Expenditures*, by Don C. Richards, and CRS Report RS21786, *The Federal Budget Deficit: A Discussion of Recent Trends*, by Gregg Esenwein, Marc Labonte, and Philip Winters.

The Federal Tax Burden.

The broadest gauge of the federal tax burden is the level of federal receipts as a percentage of output (gross domestic product, or GDP). By this measure the federal tax burden has fluctuated considerably over the past five years. In FY2000, federal receipts reached a post-World War II peak as a percentage of output, at 20.9%. By FY2004, however, receipts had fallen to 16.3% of GDP — their lowest level since 1959. In part, the fluctuations were a result of the business cycle; the long economic

---

[2] U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005-2014* (Washington: GPO, 2004), p. 8.

[3] U.S. Congressional Budget Office, *The Long-Term Budget Outlook* (Washington: GPO, December, 2003), p. 9.

boom of the 1990s helped push receipts to their record level in FY2000, which the ensuing recession and sluggish recovery helped reduce the level of revenues in subsequent years. However, policy changes, too, were responsible: significant tax cuts in 2001, 2002, and 2003 each contributed to the decline in taxes.

Another way to look at the tax burden is to compare it across income classes. In combination, the various components of the federal tax system have a progressive impact on income distribution — that is, upper-income individuals tend to pay a higher portion of their income in tax than do lower-income persons. In isolation, however, the different components of the system have different effects: the individual income tax is progressive, while payroll taxes are progressive in the lower and middle parts of the income spectrum but become regressive as incomes increase. The corporate income tax and estate tax are both progressive, although they impose only a small burden; excise taxes are regressive.

CBO has published distributional analyses for all federal taxes for each year since 1979; the studies use a consistent methodology, so the results can be compared to get an idea of the direction of federal tax policy's distributional impact over the period. According to the studies, the overall effect federal tax rate declined from 22.2% of income in 1979 to 19.6% in 2004. Over the period, the system has apparently become slightly less progressive. While the effective tax rate for each quintile of households in the income scale has declined, the decline has tended to be larger for successively higher quintiles.[4]

For further information, see CRS Report RS20087, *The Level of Taxes in the United States, 1940-2003*, by David L. Brumbaugh and Don C. Richards, and CRS Report RL32693, *Distribution of the Tax Burden Across Individuals: An Overview*, by Jane G. Gravelle and Maxim Shvedov.

Possible Tax Issues in 2005

Scheduled Expiration of Enacted Tax Cuts.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) provided a substantial tax cut that it scheduled to be phased in over the 10 years following its enactment. However, to comply with a Senate procedural rule (the "Byrd rule"), the act contained language "sunsetting" its provisions after calendar year 2010. Thus, all of EGTRRA's tax cuts expire at the end of 2010.

The most prominent provisions EGTRRA scheduled for phase-in were:

---

[4] U.S. Congressional Budget Office, *Effective Federal Tax Rates: 1997-2000* (Washington: GPO, 2003), pp. 22-23; and *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (Washington: GPO, 2004), p. 10. Both reports are available on the CBO website, at [http://www.cbo.gov/], visited Dec. 21, 2004. For the lowest to highest quintiles, respectively, the percentage-point declines in effect tax rates between 1979 and 2004 were: 1.2; 1.9; 2.1; 2.0; and 4.2.

- reduction in statutory individual income tax rates;
- creation of a new 10% tax bracket;
- an increase in the per-child tax credit;
- tax cuts for married couples designed to alleviate the "marriage tax penalty";
- repeal of the estate tax;
- tax cuts under the individual alternative minimum tax.

The Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) provided for the "acceleration" of most of EGTRRA's scheduled tax cuts — that is, it moved up the effective dates of most the tax cuts EGTRRA had scheduled to phase-in gradually, generally making them effective immediately. (The phased-in repeal of the estate tax was not accelerated by JGTRRA.) Many of JGTRRA's accelerations, however, were themselves temporary and were scheduled to expire at the end of 2004.

In 2004, Congress thus faced two "expiration" issues related to EGTRRA and JGTRRA. One was a question for the longer term: the scheduled expiration of EGTRRA's tax cuts at the end of 2010. The second was the expiration of JGTRRA's accelerations at the end of 2004. Congress addressed the second of these with enactment of the Working Families Tax Relief Act (WFTRA; P.L. 108-311). WFTRA generally extended JGTRRA's accelerations of EGTRRA's tax cuts through 2010 — that is, up to the point at which EGTRRA's cuts are scheduled to expire.

The issue of EGTRRA's scheduled expiration at the end of 2010 thus remains, and policymakers in both the Administration and Congress have indicated their desire to consider the issue during the Bush Administration's second term.

Along with its accelerations of EGTRRA's tax cuts, JGTRRA contained an increase in the alternative minimum tax exemption-amount that was effective only for 2004. WFTRA extended the increase, but only through 2005, thus posing an additional time sensitive issue, as discussed more fully below in the section on the minimum tax. Further, the tax code contains numerous other temporary tax-reducing provisions beyond those contained in EGTRRA and JGTRRA. These provisions — sometimes termed "extenders" — have typically been temporary from their inception, have been scheduled to expire at various times in the past, but have been extended by Congress. While WFTRA included an extension of many of these provisions with its extension of JGTRRA's accelerations, but the extensions were generally only through 2005, and the 109th Congress may thus consider their extension.

For additional information on the expiring provisions of EGTRRA and JGTRRA, see CRS Report RS21863, *Recent House Legislation Extending Selected Provisions of the 2001 and 2003 Tax Cuts*, by Gregg Esenwein. For information on the extenders, see CRS Report RS21830, *List of Temporary Tax Provisions: 'Extenders' Expiring in 2004,* by Pamela J. Jackson. For a comprehensive list of temporary tax code provisions and their scheduled expiration date, see U.S. Congress, Joint Committee on Taxation, *List of Expiring Federal Tax Provisions, 2004-2014* (Washington: December 23, 2004), 16 pp. (available on the Joint Committee's website at [http://www.house.gov/jct/x-71-04.pdf], visited December 28, 2004.

The Alternative Minimum Tax for Individuals.

While EGTRRA's expiration presents a timing issue focused on a specific date, the individual AMT is an issue for which time is a critical element but in a less specific way: absent legislative action, as each year passes more and more individuals will be subject to the AMT rather than the regular tax. According to one recent study, in 2001 2.4 million individual income tax returns (1.8% of the total) contained an AMT liability; in 2004 an estimated 3.5 million returns (2.6%) will have had an AMT liability. In 2010, an estimated 37.1 million returns (25.6%) will owe the AMT.[5] The portion will decline for a number of years thereafter if EGTRRA's expiration occurs as scheduled, but then will resume growth.

The reason for the increase in the applicability of the AMT is its basic mechanics. The AMT functions like a parallel income tax, with lower rates than the regular tax but with a broader base — that is, with fewer deductions, exemptions, credits, and special tax preferences than are allowable under the regular tax. Each year, a taxpayer pays either his or her regular tax or the tentative AMT, whichever is higher. Taxpayers are permitted a flat exemption amount in calculating their AMT. However, the exemption is fixed at a flat dollar amount that is not indexed for inflation. And while the AMT only has two rate brackets (26% and 28%), the bracket dividing point is likewise not indexed. In contrast, the structural features of the regular income tax — personal exemptions, the standard deduction, and rate-bracket thresholds — are indexed. Thus, as time passes and incomes grow in both real and nominal terms, the AMT exceeds the regular tax for more taxpayers. The phenomenon was magnified by the rate reductions and tax cuts for married couples provided by EGTRRA and JGTRRA as well as other tax cuts enacted in the past. As described above, Congress addressed the AMT on a temporary basis in 2001 and 2003 under EGTRRA and JGTRRA by increasing the exemption amount, thus reducing the number of taxpayers who would otherwise pay the AMT. Most recently, WFTRA extended through 2005 an exemption amount of $58,000 for married couples and $40,250 for single filers. However, WFTRA's provision expires at the end of 2005 and without additional legislative action the exemption amount will revert to its pre-EGTRRA levels of $45,000 and $33,750 for couples and singles, respectively.

The original purpose of the AMT was to ensure that no individual with substantial income measured in economic terms could use tax benefits and omissions from the tax base to reduce his or her tax liability below a certain point. Why might the AMT's increased applicability present an issue? On a practical level, there are a number of reasons policymakers may be concerned. First, taxpayers who become subject to the AMT face a higher tax liability than they otherwise would; some taxpayers moving into AMT status may thus view the applicability of the AMT as a tax increase. Second, taxpayers in AMT status are not able to fully participate in tax cuts enacted under the regular tax. For example, application of the AMT prevented

---

[5] Daniel Feenberg and James M. Poterba, "The Alternative Minimum Tax and Effective Marginal Tax Rates," *National Tax Journal*, vol. 57 part II, June 2004, p. 412.

those taxpayers subject to the AMT from fully realizing the tax cuts enacted under EGTRRA and JGTRRA. Third, the AMT introduces complexity to the tax system, and the amount of time spent in tax preparation increases for taxpayers in or near AMT status.

On a more conceptual level, the AMT can be viewed as balancing conflicting goals of the income tax. On the one hand, various deductions, exemptions, credits, and other benefits under the regular income tax are thought to be useful in promoting various activities thought to be socially desirable or conducive to economic growth. On the other hand, it is often thought desirable for a tax system to achieve a certain level of fairness, both in horizontal terms (the equal treatment of individuals in different circumstances) and vertical terms (the relative treatment of individuals at different income levels). Further, economists argue that broad-based tax systems with low rates — a characteristic of the AMT — are less damaging to economic efficiency than higher-rate systems that apply to bases laden with special benefits. With the AMT, taxpayers can use the tax benefits available under the regular tax only up to a point, where considerations of equity and efficiency trigger applicability of the AMT: the benefits' economic growth and social goals are balanced with fairness and efficiency concerns. To the extent the AMT's growth has resulted from inflation and lack of indexation, it might be argued that the AMT's advance is unintended, and the balance between equity and social and economic goals intended for the AMT has been upset.[6]

For further information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein.

Tax Reform.

Early indications are that tax reform — either incremental changes to the current system or a more fundamental reform — will be a prominent focus of the tax policy debate in 2005. President Bush, in his September, 2004, speech accepting the Republican nomination for President, called for reform whose goals would be simplification, fairness, and economic growth. Subsequent statements by the President and Administration spokesmen have reiterated the President's intent to make tax reform a second-term priority. The Administration plans to appoint a panel that will study the issue of tax reform and that will deliver a report to the Secretary of the Treasury some time in 2005.[7] The Administration has not indicated the particular nature of reform it favors — for example, whether it favors incremental changes to the current system or a more wholesale revision, or whether it favors movement towards a comprehensive income tax or adoption of a tax on consumption rather than income.

---

[6] It might be argued that the level intended by Congress is that established under the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), where the permanent exemption levels and bracket amounts and rates were established.

[7] A news release outlining the Administration's approach to studying tax reform is posted at the White House website at [http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html] (visited Dec. 27, 2004).

There have likewise been indications of congressional interest in tax reform. In the 108th Congress, numerous bills were introduced that would fundamentally reform the tax system in various ways. The content of the proposals ranged from plans for a flat-rate consumption tax (H.R. 3060/S. 1040 and S. 907) to a proposed national retail sales tax (H.R. 25/S. 1493 and H.R. 4168), to a broad set of specific changes designed to simplify the current system (H.R. 269). Looking ahead to the 109th Congress, some congressional leaders have suggested that the application of the alternative minimum tax to a growing number of taxpayers may serve as an impetus to fundamental tax reform, although the reform may be incremental in nature.[8] And in September, 2004, House Republicans made tax reform a focus of a conference that was characterized as "the beginning of an education process" in preparation for consideration of tax reform.[9] For their part, prominent Democrats voiced doubts about the range of consumption tax proposals although they did indicate support for the general idea of tax reform.[10]

Proposals for the general reform of the tax system have taken one of two conceptual forms: a tax on comprehensive measure of income; or a tax on consumption. Both types of reform proposals typically involve broadening the tax base while reducing the tax rates that apply to the base. A comprehensive income tax would apply at the same rate to all income, regardless of its use or its source, thus eliminating many of the special deductions and credits contained in the current system. A consumption tax would only apply to that portion of income that is spent on consumption and would not apply to saving. Both types of reform are generally championed on grounds of economic efficiency — because they apply more evenly across different types of income, broad-based taxes are less distorting of economic decisions and thus permit a more smoothly working economy. Because consumption taxes do not apply to saving, their adherents argue that they better promote saving and investment and thus economic growth. Critics, however, are skeptical of how responsive savers actually are to the presence or absence of taxes and point to the greater difficulty in establishing progressivity under a consumption tax. Each type of tax reform is also frequently supported on grounds of simplicity; the substantial (and apparently growing) complexity of the current tax system is often cited as a primary reason for tax reform. Skeptics, however, point out that the three goals of most tax reform plans — economic performance, equity, and efficiency — are frequently at odds, so that even the most carefully-designed reform plan cannot achieve perfection in all three areas.

Like any thorough rearrangement of economic relationships, fundamental tax reform would produce complex transition effects and there would be both winners

---

[8] See the remarks by Chairman William Thomas of the House Ways and Means Committee reported in Katherine M. Stimmel, "Thomas Says Lawmakers Must Balance Reform Goals Against What Can Be Passed," BNA *Daily Tax Report*, Nov. 19, 2004, p. G-12.

[9] Katherine M. Stimmel, "House GOP Begins Discussing Reform Plans; Meeting Seen as First Step Toward Overhaul," BNA *Daily Tax Report*, Oct. 1, 2004, p. G-1.

[10] See, for example, the testimony of Rep. Charles Rangel, ranking minority member of the House Ways and Means Committee, at the Oct. 6, 2004, hearings by the House Budget Committee, posted at the committee's website at [http://www.house.gov/budget/hearings/rangelstmnt100604.htm] (visited Dec. 27, 2004).

and losers across economic actors and taxpayers. For example, broadening of the base would necessarily entail elimination of a variety of deductions and credits favoring particular activities, investments, or types of income, and there are doubtless some who would lose more from the elimination of such preferences than they would gain from a reduction in statutory tax rates. And, in the case of a switch to a consumption tax, owners of existing capital — for example, owners of corporate stock — would register a windfall loss as a transition effect. These changes could also lead to inflation and recession, which could be serious for certain types of consumption taxes.

The complexity and magnitude of the transition effects suggest that if Congress does adopt fundamental tax reform, the path would be arduous and debate would be heated. To illustrate, Congress in the mid-1990s actively considered fundamental tax reform without adopting it: numerous reform bills were introduced and hearings were held by the tax-writing committees.[11] And even when tax reform has been achieved, it has eroded over time: the Tax Reform Act of 1986 (P.L. 99-514) was a substantial movement toward a reformed tax on comprehensive income. Over the past two decades, however, the grand compromise the act embodied — lower rates exchanged for fewer special tax benefits — has come unwound, suggesting the difficulty of crafting an enduring version of tax reform.

For additional information, see CRS Issue Brief IB95060, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, by James M. Bickley, and CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Gregg Esenwein and Jane G. Gravelle.

Major Tax Legislation, 2001-2004

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16).

On February 8, 2001, President Bush sent the outlines of a tax plan to Congress that was the same in its essentials to the tax proposal he advanced during the presidential campaign. According to Administration estimates, the tax cuts would reduce revenue by $1.6 trillion over 10 years. In the House, tax cuts similar to the President's proposals were passed in March, April, and early May as components of several different bills. The Senate passed a somewhat different tax cut plan in May, and on May 26, the House and Senate both approved a conference agreement on the bill, entitled the Economic Growth and Tax Relief Reconciliation Act of 2001. Although the congressional bill contained some differences from the President's plan, the President signed the measure on June 7; it became P.L. 107-16.

Timing was an important element of P.L. 107-16 in several ways. First, many of the act's most important provisions are "phased in"; that is, they become fully

---

[11] See, for example, U.S. Congress, House Committee on Ways and Means, *Replacing the Federal Income Tax,* 104th Cong., 1st sess., June 6, 7, and 8, 1995 (Washington: GPO, 1995), 1,055 pp.

effective only gradually, over a number of years. Second, the act contained language providing for the expiration ("sunset") of its provisions after 2010. The provision was included because of Senate procedural rules on budget reconciliation. As noted elsewhere in this report, both Act's phase-in and sunset provisions have been a focus of congressional attention since EGTRRA's enactment. As enacted, EGTRRA was estimated to reduce revenue by $1.35 trillion over the period 2001-2011.

As with the President's plan, EGTRRA's centerpiece was a **reduction in the individual income tax rates** that apply to taxable income. Prior to the act, the tax code's rates were 15%, 28%, 31%, 36%, and 39.6%; the act reduces these to 10%, 15%, 25%, 31%, and 35%. In addition, the act eliminates the overall limit on itemized deductions and phases out the tax code's restriction on personal exemptions.

Under EGTRRA's phase-in schedule, the rate reductions were not scheduled to be fully effective until 2006. At the same time, the act's application of a 10% rate to the lowest part of the lowest bracket is retroactive to January 1, 2001 — a provision designed to provide an economic stimulus. Beginning in July, 2001, the Treasury Department issued checks based on the rate reduction.

The act increased the tax code's **per-child tax credit** from prior law's $500 to a new level of $1,000, phased in over the period 2001-2010. Also, under prior law, the child tax credit is refundable only for families with three or more children. The act extends refundability to smaller families, subject to certain limitations. The act also provided that the refundable child credit would not be reduced by a taxpayer's alternative minimum tax (AMT), and that the credit would offset both a taxpayer's AMT and regular tax.

EGTRRA provided **tax reductions for married couples**. Under prior law, certain structural features of the income tax could result in a married couple paying either more or less in tax than they would as two singles — incurring a "marriage penalty" or "marriage bonus," in tax parlance. Features responsible for the uneven treatment of marital status included the standard deduction, tax-bracket widths, and the earned income tax credit (EITC). EGTRRA addressed the marriage penalty by increasing the standard deduction for couples, widening the income bracket to which the 15% tax rate applies, and altering the EITC. As with the tax-rate reductions, the tax cuts for married couples were scheduled to be gradually phased in.

EGTRRA **phased out the federal estate tax** over the period 2002-2010. The phase-out consisted of a gradual reduction in estate tax rates over the phase-out period, as well as an increase in the effective exemption delivered by the estate and gift tax unified credit.

The act provided a temporary reduction in the individual **alternative minimum tax** by increasing its exemption by $2,000 in the case of single returns and $4,000 for joint returns for the years 2001 through 2004. The exemptions under prior law were $33,750 and $45,000, respectively.

Other provisions of the act included:

- several tax benefits for education, including more generous rules for education IRAs and tax-favored tuition savings plans; permanent extension of the exclusion for employer-provided education assistance; more generous rules for deductibility of student-loan interest; and a temporary deduction for qualified education expenses.

- tax cuts for IRAs and pensions,
- more generous rules for the **adoption tax credit**,
- provision of a 25% tax credit for **employer-provided child care**; and
- an increase in the **dependent care tax credit**.

For further information, see CRS Report RL30973, *Tax Cuts: Description, Analysis, and Background.*

Job Creation and Worker Assistance Act of 2002 (JCWA; P.L. 107-147).

The final version of the Job Creation and Worker Assistance Act was approved by Congress and signed into law in March, 2002, but the act grew out of tax proposals that began moving through both chambers in late 2001 — proposals designed to provide economic stimulus in the wake of the September, 2001, terrorist attacks. The enacted version of JCWA was considerably smaller than EGTRRA; the Joint Tax Committee estimated that it would reduce revenue by an estimated $12.9 billion over 10 years. Also in contrast to EGTRRA, the enacted version of JCWA focused more on business tax cuts than tax cuts for individuals.

The act's principal components were:

- A "bonus" depreciation allowance under which firms could deduct an additional 30% of the cost of property in its first year of service. The provision was temporary and limited to property placed in service before 2005.
- An extension of the net operating loss "carryback" period (the years in the past from whose income a firm can deduct losses) to five years from two years. The provision only applied to losses in 2001 and 2002.
- A set of business tax benefits targeted at areas of New York City.
- Extension of a set of expiring tax benefits (e.g., the work opportunity tax credit, the welfare-to-work tax credit, and extension of nonrefundable credits to the alternative minimum tax), generally through 2003.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27).

On January 7, 2003, President Bush announced the details of a new tax cut proposal intended to provide a stimulus to the economy and to provide tax incentives in selected areas. According to the Joint Committee on Taxation, the revenue reduction from the plan was estimated at $1.575 trillion over FY2003 -FY2013.

The President's proposal consisted of an economic stimulus component and a set of more narrow, targeted tax cuts. The stimulus portion consisted primarily of acceleration of several tax cuts for individuals that were enacted by EGTRRA in 2001 but that were scheduled to be phased in only gradually (see the preceding section on EGTRRA). The Administration proposed to make the reductions effective for 2003 rather than the scheduled phase-in dates. The proposed accelerations included tax rate reductions, tax cuts for married couples, and an increased child tax credit. Another prominent part of the President's 2003 plan was a proposal to move toward "integration" of the taxation of corporate-source income by eliminating individual income taxes on dividends and by permitting a "step up in basis" for capital gains resulting from retained earnings. The Administration also proposed to increase the "expensing" allowance for small business investment in equipment to $75,000 from current law's $25,000.

Prominent among the more targeted tax cuts proposed with the budget were two new tax-favored savings vehicles that would replace Individual Retirement Accounts (IRAs) and that would have less binding restrictions than current law's IRAs; a set of new tax incentives for charitable giving, including a deduction for non-itemizers; a number of tax benefits related to health care, including a long-term care insurance deduction for non-itemizers; a set of tax benefits related to energy production and conservation; and permanent extension of current law's temporary research and experimentation tax credit.

On May 23, 2003, the House and Senate agreed to the conference report for H.R. 2, the Jobs and Growth Tax Relief and Reconciliation Act (JGTRRA; P.L. 108-27). In broad outline, the act contained the principal elements of the stimulus part of the President's tax-cut proposal. The President signed the bill into law on May 28. JGTRRA's conference agreement contained an estimated $350 billion in reduced revenues and increased outlays from FY2003 through FY2013, including $320 billion in tax cuts and $30 billion in outlay increases. The principal outlay provisions in the package established a $20 billion fund to provide fiscal relief to state governments. The principal tax components of JGTRRA were:

- Acceleration to 2003 of the individual income tax cuts enacted and scheduled for phase-in under EGTRRA.
- EGTRRA had scheduled a gradual increase in the child tax credit from prior law's $500 to a level of $1,000 by 2010. JGTRRA provided for the $1,000 to be effective in 2003 and 2004, but its acceleration was temporary and provided for the credit to revert in 2005 to the lower, phase-in schedule provided by EGTRRA ($700 in 2005 - 2008, $800 in 2009, and $1,000 in 2010).
- For 2003 and 2004 only, the standard deduction and 15% tax bracket for married taxpayers were made twice those for singles. In a manner similar to the child credit, these provisions were scheduled to revert to EGTRRA's schedule beginning in 2005.
- The alternative minimum tax exemption amount was increased by $9,000 for married couples and $4,500 for singles for 2003 and 2004.The maximum expensing benefit for small business investment was temporarily increased from prior law's $25,000 to $100,000 for

2003, 2004, and 2005. The provision's phase-out threshold was increased from $200,000 to $400,000 over the same time period.

- The temporary "bonus" depreciation allowance originally passed in March 2002 was increased and extended to allow for a 50% first year deduction (up from 30%) for the period between May 5, 2003 and December 31, 2004.
- The conference agreement reduced the tax rate on both dividends and capital gains to 15% for taxpayers in the higher tax brackets and 5% for those in the lower tax brackets for 2003 through 2008. (The tax rate for those in the lower tax brackets would be 0% in 2008.) The dividend provision was applied to both domestic and foreign corporations.

For additional information, see CRS Report RL31907, *The 2003 Tax Cut: Proposals and Issues,* by David L. Brumbaugh and Don C. Richards.

Working Families Tax Relief Act of 2004 (H.R. 1308; P.L. 108-311).

The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA) provided a number of substantial tax cuts that were scheduled to be phased in gradually over the 10 years following EGTRRA's enactment. As discussed more fully above (see the section on "Scheduled Expiration of Tax Cuts") the tax cuts are generally scheduled to expire at the end of 2010. In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) accelerated a number of EGTRRA's phased-in tax cuts, including reduction of individual income tax rates and tax cuts for married couples and families, making EGTRRA's cuts fully effective in 2003. However, JGTRRA's accelerations were themselves scheduled to expire at the end of 2004. A principal thrust of the Working Families Tax Relief Act (WFTRA) was to extend JGTRRA's tax cuts for varying lengths of time. The measure was approved by Congress on September 23, 2004, and was signed into law on October 4. According to Joint Tax Committee revenue estimates, WFTRA will reduce revenue by $132.8 billion over five years and $146.9 billion over 10 years.

WFTRA's provisions:

- extended the increased ($1,000) child tax credit through 2009;
- extended tax cuts for married couples through 2008;
- extended the widened 10% tax-rate bracket through 2010;
- extended the increased alternative minimum tax exclusion through 2005;
- accelerated the refundability of the child tax credit to 2004; and
- included combat pay in income that qualifies for the refundable child tax credit and the earned income tax credit.

In addition to the expiring provisions of EGTRRA and JGTRRA, the tax code has long contained a set of additional temporary tax benefits that are generally designed to promote various types of investments and activities thought to be beneficial. Prominent examples include the research and experimentation tax credit, the work opportunities tax credit, and the welfare to work tax credit. WFTRA extended a number of these so-called "extenders," generally through 2005.

The American Jobs Creation Act (H.R. 4520; P.L. 108-357).

Congress passed the American Jobs Creation Act (AJCA) in October, 2004. The principal concern of the bill was business taxation. As discussed more fully below (see the entry under "Selected Issues"), the bill began as a remedy to a long-running dispute between the United States and the European Union over the U.S. extraterritorial income exclusion (ETI) tax benefit for exporters. The scope of the enacted bill, however, was considerably broader. In general outline, the act repealed ETI while implementing a mix of tax cuts for both domestic and multinational U.S. businesses. The act achieved estimated revenue neutrality with a set of provisions generally in the area of corporate tax compliance.

AJCA provisions are numerous and apply to a broad array of tax code sections. In general terms however, the act's most important provisions were:

- repeal of the ETI export tax benefit;
- a variety of tax cuts generally favoring domestic (as opposed to foreign) investment. (Chief among these was a new 9% deduction limited to domestic production.)
- Several tax cuts for multinational firms, including more generous foreign tax credit rules for the treatment of interest expense and a consolidation of the several separate foreign tax credit limitations that existed under prior law.
- A set of revenue raisers (in addition to ETI's repeal) including provisions aimed at restricting corporate tax shelters, provisions designed to improve fuel tax compliance, and a provision restricting tax benefits available from lease transactions involving tax-indifferent entities.

For additional information on AJCA, see CRS Report RL32652, *The 2004 Corporate Tax and FSC/ETI Bill: The American Jobs Creation Act of 2004*, by David L. Brumbaugh.