General Explanations of the Administration's Fiscal Year 2007 Revenue Proposals

Department of the Treasury
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Introduction

This report summarizes the revenue proposals in the Administration's Fiscal Year 2007 Budget. These proposals include making permanent the tax relief enacted in 2001 and 2003, which is essential for promoting economic growth and higher levels of income in the future. The other proposals, also intended to strengthen the American economy, affect a wide range of areas, including simplifying and encouraging saving, encouraging entrepreneurship and investment, investing in health care, providing incentives for charitable giving, strengthening education, assisting distressed areas, and protecting the environment. Additionally included are proposals to simplify the tax law for families, strengthen the employer based pension system, close loopholes and improve tax compliance, improve tax administration, modify the Energy Policy Act of 2005, and extend expiring tax provisions.

Next Steps on Tax Reform

Americans deserve a tax system that is simple, fair, and pro-growth – in tune with our dynamic, 21st century economy. The tax system should allow taxpayers to make decisions based on economic merit, free of tax-induced distortions. The bipartisan and unanimous Report of the President's Advisory Panel on Federal Tax Reform has provided a strong foundation for a national discussion on ways to ensure that our tax system better meets the needs of today's economy.

The President has proposed several changes that move the tax code in this direction. The Budget includes proposals to make health care more affordable to a mobile labor force, to promote savings for all Americans, to encourage investment by entrepreneurs, and to enhance our competitiveness by lowering the cost of capital. In the coming months, the Treasury Department will continue to study tax reform and engage in a public dialogue on this important issue.

A New Dynamic Analysis Division within the Office of Tax Policy

Dynamic analysis emphasizes the potential economic benefits of tax changes for increasing and promoting economic growth and is particularly important for evaluating broad reforms of the tax system. Dynamic analysis recognizes a more comprehensive range of behavioral responses to tax changes, including how tax changes affect the size of the economy.

The FY 2007 Budget would create a new Dynamic Analysis Division within the Treasury Department's Office of Tax Policy to conduct dynamic analysis of major tax policy proposals and tax reform options. It is expected that the Office of Tax Policy will conduct a dynamic analysis of the tax proposals included in the President's FY 2007 Budget as a supplement to the Mid-Session Review in July.

MAKE PERMANENT CERTAIN TAX RELIEF ENACTED IN 2001 AND 2003

Permanently Extend Certain Provisions of the 2001 Tax Relief and the 2003 Jobs and Growth Tax Relief

Current Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a new 10-percent individual income tax rate bracket, reduced marginal income tax rates for individuals, doubled the child credit and extended its refundability, reduced marriage penalties, eliminated the phase-out of personal exemptions and the limitation on certain itemized deductions for higher-income taxpayers, provided additional incentives for education, increased IRA and pension incentives, provided relief from the alternative minimum tax (AMT), eliminated the estate and generation-skipping transfer taxes, and modified the gift tax. These and several other provisions of EGTRRA sunset on December 31, 2010.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the amount of qualifying property that can be expensed in the year of purchase rather than being depreciated and lowered the tax rates on qualifying dividends and on capital gains. The liberalized expensing provision, as extended, sunsets on December 31, 2007. The dividend and capital gains provisions sunset on December 31, 2008.

Reasons for Change

The tax relief and incentives to work, save, and invest provided by EGTRRA and JGTRRA are essential to the long-run performance of the economy. All taxpayers should have the certainty of knowing that the provisions of EGTRRA will extend beyond 2010. Taxpayers plan for periods far beyond the scheduled sunset dates of the EGTRRA and JGTRRA provisions when saving for their children's education, undertaking new business ventures, planning for retirement, and planning future contributions to charity and bequests for their children. Taxpayers require the certainty that can be provided today by permanently extending the provisions of EGTRRA and JGTRRA. Permanent extension of the provisions is essential for promoting growth and higher levels of income in the future.

Proposal

The provisions of EGTRRA that sunset on December 31, 2010 would be permanently extended. The provisions of JGTRRA that sunset on December 31, 2007 and December 31, 2008 would be permanently extended.

Revenue Estimate[1]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
83	-531	-7,736	-37,023	-13,596	-119,388	-178,274	-1,412,188

[1] The estimate includes both receipt and outlay effects. The outlay effect is $59,155 for 2007-2016.

TAX INCENTIVES

Simplify and Encourage Saving

EXPAND TAX-FREE SAVINGS OPPORTUNITIES

Current Law

Current law provides multiple tax-preferred individual savings accounts to encourage saving for retirement, education, and health expenses. The accounts have overlapping goals but are subject to different sets of rules regulating eligibility, contribution limits, tax treatment, and withdrawal restrictions. Individual Retirement Accounts (IRAs), including traditional, nondeductible, and Roth IRAs, are primarily intended to encourage retirement saving, but can also be used for certain education, medical, and other non-retirement expenses. Each of the three types of IRAs is subject to a different set of rules regulating eligibility and tax treatment. Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs) are both intended to encourage saving for education, but each is subject to different rules. Archer Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs) are intended to encourage saving for medical expenses.

Individual Retirement Accounts: Under current law, individuals under age 70½ may make contributions to a traditional IRA, subject to certain limits. The contributions are generally deductible; however, the deduction is phased out for workers with incomes above certain levels who are covered by an employer-sponsored retirement plan. For taxpayers covered by employer plans in 2006, the deduction is phased out for single and head-of-household filers with modified-adjusted gross income[2] (AGI) between $50,000 and $60,000, for married filing jointly filers with modified-AGI between $75,000 and $85,000 (increasing to $80,000 to $100,000 in 2007), and for married filing separately filers with modified-AGI between $0 and $10,000. For a married, filing jointly taxpayer who is not covered, but whose spouse is covered by an employer-sponsored retirement plan, the deduction is phased out with modified-AGI between $150,000 and $160,000. Account earnings are not includible in gross income until distributed. Distributions (including both contributions and account earnings) are includible in gross income for income tax purposes.

To the extent a taxpayer cannot or does not make deductible contributions to a traditional IRA, a taxpayer under age 70½ may make nondeductible contributions. In this case, distributions representing a return of basis are not includible in gross income, while distributions representing account earnings are includible in gross income. There is no income limit for nondeductible contributions to a traditional IRA.

Individuals of any age may make contributions to a Roth IRA. The contributions are not deductible. Allowable contributions are phased out for workers with incomes above certain levels. Contributions are phased out for single or head-of-household filers with modified-AGI

[2] AGI plus income from education savings bonds, interest paid on education loans, employer-provided adoption assistance benefits, IRA deductions, deductions for qualified higher education expenses, and certain other adjustments.

between $95,000 and $110,000, for married filing jointly filers with modified-AGI between $150,000 and $160,000, and for married filing-separate filers with modified-AGI between $0 and $10,000. Account earnings accumulate tax free, and qualified distributions (including account earnings) are not included in gross income for income tax purposes. Nonqualified distributions from Roth IRAs are included in income (to the extent they exceed basis) and subject to an additional tax. Distributions are deemed to come from basis first.

The annual aggregate limit on contributions to all of a taxpayer's IRAs (traditional, nondeductible, and Roth) is the lesser of earnings or $4,000 for 2006 ($5,000 for individuals age 50 and over). The contribution limit is scheduled to increase to $5,000 ($6,000 for individuals age 50 and over) in 2008.

Taxpayers with AGI of $100,000 or less and who are not married filing separately can convert a traditional IRA to a Roth IRA. In general, the conversion amount is included in gross income (but not for purposes of the $100,000 limit).

Early distributions from IRAs are generally subject to an additional 10 percent tax. The tax is imposed on the portion of an early distribution that is includible in gross income. It applies in addition to ordinary income taxes on the distribution. The additional tax does not apply to a rollover to an employer plan or IRA, or if the distribution is made in the cases of death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher-education expenses, health insurance expenses of unemployed individuals, or as part of a series of substantially equal periodic payments.

Minimum distribution rules require that, beginning at age 70½, the entire amount of a traditional IRA be distributed over the expected life of the individual (or the joint lives of the individual and a designated beneficiary). Roth IRAs are not subject to minimum distribution rules during the account owner's lifetime.

<u>Coverdell Education Savings Accounts:</u> Taxpayers may elect to contribute up to $2,000 per year to a Coverdell Education Savings Account (ESA) for beneficiaries under age 18. The contribution limit is phased out for single filers with modified-AGI between $95,000 and $110,000 and for joint filers with modified-AGI between $190,000 and $220,000. Contributions are not deductible, but earnings on contributions accumulate tax-free. Distributions are excludable from gross income to the extent they do not exceed qualified education expenses that are incurred during the year the distributions are made and that are not used to claim another tax benefit (such as an education tax credit or a tax-free distribution from a qualified tuition program). The earnings portion of a distribution not used to cover qualified education expenses is includible in the gross income of the beneficiary and is generally subject to an additional 10 percent tax.

Except in the case of a special needs beneficiary, when a beneficiary reaches age 30, the account balance is deemed to have been distributed for nonqualified purposes. However, prior to the beneficiary reaching age 30, tax-free (and penalty-free) rollovers of account balances may be made to an ESA benefiting another family member.

Section 529 Qualified Tuition Programs: Contributions to a QTP are not deductible from income for federal tax purposes, but earnings on contributions accumulate tax-free. Taxpayers may exclude from gross income amounts distributed from a QTP and used for qualified higher education expenses, so long as the distribution is not used for the same educational expenses for which another tax benefit (such as an education tax credit or a tax-free distribution from an ESA) is claimed. Nonqualified distributions are subject to an additional tax. A change in the designated beneficiary of an account is not treated as a distribution, and therefore is not subject to income tax, if the new beneficiary is a member of the family of the prior beneficiary. Neither contributors nor beneficiaries may direct the investment of the account.

There is no specific dollar cap on annual contributions to a QTP. In addition, there is no limit on contributions to a QTP account based on the contributor's income, contributions are allowed at any time during the beneficiary's lifetime, and the account can remain open after the beneficiary reaches age 30. However, a QTP must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of amounts necessary to provide for the qualified higher education expenses of the beneficiary.

Some states allow contributions to be excluded from income for state income tax purposes.

Health Savings Accounts: Individuals who are covered by a qualifying high deductible health plan and not covered by any non-high deductible health plan other than certain permitted or disregarded coverage may contribute to a Health Savings Account (HSA) that can be used to reimburse the individuals' and their dependents' health expenses. Employers may also make contributions to employees' HSAs. The high deductible health plan may be provided by an employer or purchased in the individual insurance market. Individuals who are eligible for Medicare or to be claimed as a dependent on someone else's return may not contribute to an HSA. Contributions to HSAs are deductible and qualified distributions are excluded from gross income. Nonqualified distributions are subject to income tax and, if taken prior to age 65, an additional 10 percent tax.

Archer Medical Savings Accounts: Self-employed individuals and individuals employed by small employers maintaining a high deductible health plan (defined more restrictively than under the HSA) are allowed to accumulate funds in an Archer Medical Savings Account (MSA) on a tax-preferred basis to pay for medical expenses. An individual is eligible to establish an MSA only if the employee (or the employee's spouse) is covered by a high-deductible health plan (and not covered by any non-high deductible health plan). Although individuals with MSAs can continue to contribute to them as long as they are with an MSA participating employer, no new MSAs are permitted after the end of 2005 except with respect to individuals being hired after 2005 by an MSA-participating employer. Contributions to MSAs are deductible and qualified distributions are excluded from gross income. Nonqualified distributions are subject to income tax and, if taken prior to age 65, an additional 15 percent tax.

Reasons for Change

The plethora of individual savings accounts, each subject to different rules regarding eligibility, contributions, tax treatment, and withdrawal, creates complexity and redundancy in the Code. Taxpayers must determine their eligibility for each account separately and then must decide which plan or plans are best for them given their circumstances. Furthermore, as their circumstances change over time, taxpayers must continually re-evaluate their eligibility for each plan and which best meets their needs. The current list of non-retirement exceptions within IRAs weakens the focus on retirement saving, and the IRA exceptions and special purpose savings vehicles place a burden on taxpayers to document that withdrawals are used for certain purposes that Congress has deemed qualified. In addition, the restrictions on withdrawals and additional tax on early distributions discourage many taxpayers from making contributions because they are concerned about the inability to access the funds should they need them. Consolidating the three types of IRAs under current law into one account dedicated solely to retirement, and creating a new account that could be used to save for any reason would simplify the taxpayer's decision-making process while further encouraging savings.

Savings will be further simplified and encouraged by administrative changes to the tax filing process that, beginning in the 2007 filing season, will allow taxpayers to direct that their tax refunds be directly deposited into more than one account. Consequently, taxpayers will be able, for example, to direct that a portion of their tax refunds be deposited into a Retirement Savings Account or Lifetime Savings Account described below. Simplifying the rules, making savings opportunities universally available, and making it easier for people to set money aside through direct deposit will complement the Administration's commitment to programs focusing on financial education and, specifically, retirement planning.

Proposal

The proposal would consolidate the three types of current law IRAs into a single account: a Retirement Savings Account (RSA). RSAs would be dedicated solely to retirement savings; other withdrawals would be subject to tax and penalty as described below. Instead of a list of exceptions for penalty-free early withdrawals, a new account, a Lifetime Savings Account (LSA) would be created that could be used to save for any purpose, including retirement savings, health care, emergencies, and education.

Individuals could contribute up to $5,000 per year (or earnings includible in gross income, if less) to their RSA. As under current law IRAs, for an individual who is married filing a joint return, the compensation limitation will only be binding if the combined includible compensation of the spouses is less than $10,000. No income limits would apply to RSA contributions. Contributions would have to be in cash. Contributions would be nondeductible, but earnings would accumulate tax-free, and qualified distributions would be excluded from gross income. The RSA contribution limit would be indexed for inflation.

Qualified distributions from the retirement account would be distributions made after age 58 or in the event of death or disability. Any other distribution would be a nonqualified distribution and, as with current non-qualified distributions from Roth IRAs, would be includible in income (to the extent it exceeds basis) and subject to a 10 percent additional tax. Distributions would be deemed to come from basis first. As with current law Roth IRAs, no minimum required distribution rules would apply to RSAs during the account owner's lifetime. Married individuals could roll amounts from their RSA over to their spouses' RSA.

Existing Roth IRAs would be renamed RSAs and be made subject to the new rules for RSAs. Existing traditional and nondeductible IRAs could be converted into an RSA by taking the conversion amount into gross income, similar to a current-law Roth conversion. However, no income limit would apply to the ability to convert. Taxpayers who convert IRAs to RSAs before January 1, 2008, could include the conversion amount in income ratably over 4 years. Conversions made on or after January 1, 2008, would be included in income in the year of the conversion. Existing traditional or nondeductible IRAs that are not converted to RSAs could not accept any new contributions. New traditional IRAs could be created to accommodate rollovers from employer plans, but they could not accept any new individual contributions. Individuals wishing to roll an amount directly from an employer plan to an RSA could do so by taking the rollover amount (excluding basis) into gross income (i.e., "converting" the rollover, similar to a current law Roth conversion).

Amounts converted to an RSA from a traditional IRA or from an Employer Retirement Savings Account (ERSA) would be subject to a 5-year holding period. Distributions attributable to a conversion from a traditional IRA or ERSA (other than amounts attributable to a Roth-type account in an ERSA) prior to the end of the 5-year period starting with the year the conversion was made or, if earlier, the date on which the individual turns 58, becomes disabled, or dies would be subject to an additional 10 percent early distribution tax on the entire amount. The 5-year period is separately determined for each conversion contribution. To determine the amount attributable to a conversion, a distribution is treated as made in the following order: regular contributions; conversion contributions (on a first-in-first-out basis); earnings. To the extent a distribution is treated as made for a conversion contribution, it is treated as made first from the portion, if any, that was required to be included in gross income because of the conversion.

Individuals could contribute up to $5,000 per year to their LSA, regardless of wage income. No income limits would apply to LSA contributions. Contributions would have to be in cash. The time period for which the contribution limit applies is the calendar year. Contributions would be nondeductible, but earnings would accumulate tax-free, and all distributions would be excluded from gross income, regardless of the individual's age or use of the distribution. As with current law Roth IRAs, no minimum required distribution rules would apply to LSAs during the account owner's lifetime.

Contribution limits would apply to all accounts held in an individual's name, rather than to contributors. Thus, contributors could make annual contributions of up to $5,000 each to the accounts of other individuals, but the aggregate of all contributions to all accounts held in a given individual's name could not exceed $5,000. The LSA contribution limit would be indexed for inflation.

Control over an account in a minor's name would be exercised exclusively for the benefit of the minor, until the minor reached the age of majority (determined under applicable state law), by the minor's parent or legal guardian acting in that capacity. Married individuals could roll amounts from their LSAs over to their spouses' LSAs.

Taxpayers would be able to convert balances in Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified Tuition Plans (QTPs) to LSA balances. All conversions made before

January 1, 2008, would be on a tax-free basis, subject to the following limitations. An amount can be rolled into an individual's LSA from a QTP only if that individual was the beneficiary of the QTP or ESA as of December 31, 2005. The amount that can be rolled over to an LSA from an ESA is limited to the sum of the amount in the accounts as of December 31, 2005, plus any contributions to and earnings on the accounts in 2006. The amount that can be rolled over to any LSA from a QTP is limited to the sum of (i) the lesser of $50,000 or the amount in the QTP as of December 31, 2005, plus (ii) any contributions and earnings to the QTP during 2006. Total rollovers to an individual's LSA attributable to 2006 contributions to the individual's ESAs and QTPs cannot exceed $5,000 (plus any earnings on those contributions).

QTPs would continue to exist as separate types of accounts, but could be offered inside an LSA. For example, state agencies that administer QTPs could offer LSAs with the same investment options available under the QTP. The plan administrator would be freed from the additional reporting requirements of a QTP for investments in an LSA, but investors would be subject to the annual LSA contribution limit. Distributions for purposes other than education would not be subject to federal income-tax or penalties. However, states would be free to provide state tax incentives, and administrators would be free to provide investment incentives, for savings used for educational purposes.

The Saver's Credit would apply to contributions to an RSA but would not apply to contributions to an LSA.

Both LSAs and RSAs would become effective beginning on January 1, 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	4,796	10,407	7,507	3,970	-383	26,297	-122

CONSOLIDATE EMPLOYER-BASED SAVINGS ACCOUNTS

Current Law

Qualified Retirement Plans: Under Code section 401, employers may establish for the benefit of employees a retirement plan that may qualify for tax benefits, including a tax deduction to the employer for contributions, a tax deferral to the employee for elective contributions and their earnings, and a tax exemption for the fund established to pay benefits. To qualify for tax benefits, the plan must satisfy multiple requirements. Among the requirements, the plan may not discriminate in favor of highly-compensated employees (HCEs) with regard either to coverage or to amount or availability of contributions or benefits. The following cover some, but not all, of the defined-contribution plan rules.

Contribution Limits. The total annual contribution to a participant's account may not exceed the lesser of $44,000 or 100 percent of compensation.

General Nondiscrimination Requirement. Qualified plans, both defined-benefit and defined-contribution, must comply with the section 401(a)(4) prohibition on contributions or benefits that discriminate in favor of HCEs. Detailed regulations spell out the calculations required for satisfying this provision, including optional safe harbors and a general test for nondiscrimination.

Contribution Tests. In addition to the general nondiscrimination requirement, defined-contribution plans that have after-tax contributions or matching contributions are subject to the actual contribution percentage (ACP) test. This test measures the contribution rate to HCEs' accounts relative to the contribution rate to non-highly-compensated employees' (NHCEs') accounts. To satisfy the test, the ACP of HCEs generally cannot exceed the following limits: 200 percent of the NHCEs' ACP if the NHCEs' ACP is 2 percent or less; two percentage points over the NHCEs' ACP if the NHCEs' ACP is between 2 percent and 8 percent; or 125 percent of the NHCEs' ACP if the NHCEs' ACP is 8 percent or more.

Three "safe-harbor" designs are deemed to satisfy the ACP test automatically for employer matching contributions (up to 6 percent of compensation) that do not increase with an employee's rate of contributions or elective deferrals. In the first, vested employer matching contributions on behalf of NHCEs are equal to 100 percent of elective deferrals up to 3 percent of compensation, and 50 percent of elective deferrals between 3 and 5 percent of compensation. In the second, vested employer matching contributions follow an alternative matching formula such that the aggregate amount of matching contributions is no less than it would be under the first design. In the third, vested employer non-elective contributions are at least 3 percent of compensation made on behalf of all eligible NHCEs.

Vesting. In general, employer contributions must vest at least as quickly as under one of the following schedules. Under graded vesting, 20 percent of the benefit is vested after three years of service and an additional 20 percent vests with each additional year of service, so that the employee is fully vested after seven years of service. Under cliff vesting, the employee has no vested interest until five years of service has been completed, but is then fully vested. However, matching contributions must vest more quickly: under graded vesting, the first 20 percent must vest after two years of service, so that the employee is fully vested after six years of service, and under cliff vesting, the employee becomes fully vested after three years of service.

401(k) plans. Private employers may establish 401(k) plans, which allow participants to choose to take compensation in the form of cash or a contribution to a defined-contribution plan ("elective deferral"). In addition to the rules applying to qualified defined-contribution plans, 401(k) plans are subject to additional requirements.

Annual deferrals under a 401(k) plan may not exceed $15,000 in 2006. Participants aged 50 or over may make additional "catch-up" deferrals of up to $5,000. Elective deferrals are immediately fully vested.

401(k) plans are subject to an actual deferral percentage (ADP) test, which generally measures employees' elective-deferral rates. In applying the ADP test, the same numerical limits are used as under the ACP test. Three 401(k)-plan "safe-harbor" designs (similar to the safe-harbor designs for the ACP test described above) are deemed to satisfy the ADP test automatically.

SIMPLE 401(k) plans. Employers with 100 or fewer employees and no other retirement plan may establish SIMPLE 401(k) plans. Deferrals of SIMPLE participants may not exceed $10,000. SIMPLE participants aged 50 or over may make additional "catch-up" deferrals of up to $2,500. All contributions are immediately fully vested. In lieu of the ADP test, SIMPLE plans are subject to special contribution requirements, including a lower annual elective deferral limit and either a matching contribution not exceeding 3 percent of compensation or non-elective contribution of 2 percent of compensation.[3]

Thrift plans. Employers may establish thrift plans under which participants may choose to make after-tax cash contributions. Such after-tax contributions, along with any matching contributions that an employer elects to make, are subject to the ACP test (without the availability of an ACP safe harbor). Employee contributions under a thrift plan are not subject to the $15,000 limit that applies to employee pre-tax deferrals.

Roth-treatment of contributions. Effective after December 31, 2005, participants in 401(k) and 403(b) plans can elect Roth treatment for their contributions: That is, contributions would not be excluded from income and distributions would not be included in income. Roth contributions must be accounted for in a separate account. There are no required minimum distributions during an employee's lifetime, but heirs, other than a spouse, are subject to required minimum distributions.

Salary reduction simplified employee pensions (SARSEPs). Employees can elect to have contributions made to a SARSEP or to receive the amount in cash. The amount the employee elects to have contributed to the SARSEP is not currently includible in income and is limited to the dollar limit applicable to employee deferrals in a 401(k) plan. SARSEPs are available only for employers who had 25 or fewer eligible employees at all times during the prior taxable year and are subject to a special nondiscrimination test. The rules permitting SARSEPs were repealed

[3] Employer contributions and employee deferrals may be made to SIMPLE IRAs under rules very similar to those applicable to SIMPLE 401(k) plans.

in 1996, but employee deferral contributions can still be made to SARSEPs that were established prior to January 1, 1997.

403(b) plans: Section 501(c)(3) organizations and public schools may establish tax-sheltered annuity plans, also called 403(b) plans. The rules applicable to these plans are different in certain respects than rules applicable to qualified plans under section 401. Benefits may generally only be provided through the purchase of annuities or contributions to a custodial account invested in mutual funds. Contribution limits (including catch-ups), deferral limits, and minimum distribution rules are generally the same as for 401(k) plans. However, certain employees with 15 years of service may defer additional amounts according to a complicated three-part formula. Some 403(b) plans are subject to some nondiscrimination rules.

Governmental 457(b) plans: State and local governments may establish eligible plans under section 457(b).[4] In general, these plans are subject to different rules than qualified plans that are defined under section 401. Contributions and plan earnings are tax-deferred until withdrawal. Contributions may not exceed the lesser of 100 percent of compensation or $15,000 in 2006. However, participants may make additional contributions of up to twice the standard amount are permitted in the last three years before normal retirement age. Additional "catch-up" contributions of up to $5,000 may be made for participants age 50 or over.

Reasons for Change

The rules covering employer retirement plans are among the lengthiest and most complicated sections of the tax code and associated regulations. The extreme complexity imposes substantial compliance, administrative, and enforcement costs on employers, participants, and the government (and hence, taxpayers in general). Moreover, because employer sponsorship of a retirement plan is voluntary, the complexity discourages many employers from offering a plan at all. This is especially true of the small employers who together employ about two-fifths of American workers. Complexity is often cited as a reason the coverage rate under an employer retirement plan has not grown above about 50 percent overall, and has remained under 25 percent among employees of small firms. Reducing unnecessary complexity in the employer plan area would save significant compliance costs and would encourage additional coverage and retirement saving.

Proposal

The proposal would consolidate those types of defined-contribution accounts that permit employee deferrals or employee after-tax contributions, including 401(k), SIMPLE 401(k), Thrift, 403(b), and Governmental 457(b) plans, as well as SIMPLE IRAs and SARSEPs, into Employer Retirement Savings Accounts (ERSAs), which would be available to all employers and have simplified qualification requirements.

The proposal would become effective for years beginning after December 31, 2006.

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[4] Tax-exempt organizations are also permitted to establish eligible section 457(b) plans, but such plans are not funded arrangements and are generally limited to management or highly compensated employees.

ERSAs would follow the existing rules for 401(k) plans, subject to the plan qualification simplifications described below. Thus, employees could defer wages of up to $15,000 annually, with employees aged 50 and older able to defer an additional $5,000 in 2006. The maximum total contribution (including employer contributions) to ERSAs would be the lesser of 100 percent of compensation or $44,000 in 2006. The taxability of contributions and distributions from an ERSA would be the same as contributions and distributions from the plans that the ERSA would be replacing. Thus, contributions could be pre-tax deferrals or after-tax employee contributions or Roth contributions, depending on the design of the plan. Distributions of Roth and non-Roth after-tax employee contributions and qualified distributions of earnings on Roth contributions would not be included in income. All other distributions would be included in the participants' income.

Existing 401(k) and Thrift plans would be renamed ERSAs and could continue to operate as before, subject to the simplification described below. Existing SIMPLE 401(k) plans, SIMPLE IRAs, SARSEPs, 403(b) plans, and governmental 457(b) plans could be renamed ERSAs and be subject to ERSA rules, or could continue to be held separately, but if held separately could not accept any new contributions after December 31, 2007, with a special transition for collectively bargained plans and plans sponsored by state and local governments.

Special Rule for Small Employers. Employers that had 10 or fewer employees making at least $5,000 during the prior year would be able to fund an ERSA by contributing to a custodial account, similar to a current-law IRA, provided the employer's contributions satisfy the design-based ERSA safe harbor described below. This custodial account would provide annual reporting relief for small employers as well as relief from most of the ERISA fiduciary rules under circumstances similar to the fiduciary relief currently provided to sponsors of SIMPLE IRAs.

ERSA Nondiscrimination Testing. The following single test would apply for satisfying the nondiscrimination requirements with respect to contributions for ERSAs: the average contribution percentage of HCEs could not exceed 200 percent of NHCEs' percentage if the NHCEs' average contribution percentage is 6 percent or less. In cases in which the NHCEs' average contribution percentage exceeds 6 percent, the goal of increasing contributions among NHCEs would be deemed satisfied, and no nondiscrimination testing would apply. For this purpose, "contribution percentage" would be calculated for each employee as the sum of all employee and employer contributions divided by the employee's compensation. The ACP and ADP tests would be repealed. Plans sponsored by state and local governments or churches would not be subject to this test. A plan sponsored by a section 501(c)(3) organization would not be subject to this nondiscrimination test (unless the plan permits after-tax or matching contributions) but would be required to permit all employees of the organization to participate.

ERSA Safe Harbor. The design-based safe harbor described below would be sufficient to satisfy the nondiscrimination test for ERSAs described above. The design of the plan must be such that all eligible NHCEs are eligible to receive fully vested employer contributions (including matching or non-elective contributions, but not including employee elective deferrals or after-tax contributions) of at least 3 percent of compensation. To the extent that the employer contributions of 3 percent of compensation for NHCEs are matching contributions rather than non-elective contributions, the match formula must be one of two qualifying formulas. The first formula would be a 50 percent employer match for the elective contributions of the employee up to 6 percent of the employee's compensation. The second would be any alternative formula such that the rate of an employer's matching contribution does not increase as the rate of an employee's elective contributions increases, and the aggregate amount of matching contributions at such rate of elective contribution is at least equal to the aggregate amount of matching contributions which would be made if matching contributions were made on the basis of the percentages described in the first formula. In addition, the rate of matching contribution with respect to an HCE at any rate of elective contribution cannot be greater than that with respect to an NHCE.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	-542	-579	-618	-1,826	-3,565	-20,063

ESTABLISH INDIVIDUAL DEVELOPMENT ACCOUNTS (IDAS)

Current Law

Under section 25B, certain low-income taxpayers are allowed a non-refundable credit for qualified retirement savings contributions up to $2,000. The maximum credit rate is 50 percent and is phased out for single filers with adjusted gross income between $15,000 and $25,000 ($22,500 and 37,500 for head of households and $30,000 and $50,000 for joint returns). The credit does not apply to contributions made after December 31, 2006. No other current tax provision is specifically targeted to encourage low-income families to save and develop a pool of capital to be used for purposes such as a first-time home purchase, higher education expenses, or small business capitalization.

Individual Development Accounts (IDAs) were first authorized under the Personal Work and Responsibility Act of 1996. The Assets for Independence Act of 1998 established a five-year IDA demonstration program, with an annual appropriation of $25 million. Under the program, which the Department of Health and Human Services administers, an IDA can be opened by certain individuals who meet a net worth test and are eligible for the Earned Income Tax Credit or for Temporary Assistance for Needy Families (the successor to AFDC). Individuals' contributions are not deductible but are matched by contributions from a program run by a state or a participating nonprofit organization. The matching contributions and their earnings are not taxable to the individual. Withdrawals can be made for higher education, first-home purchase, or small business capitalization. Matching amounts are typically held separately, and withdrawals must be paid directly to a mortgage provider, institution of higher education, or business capitalization account at a financial institution. Match rates chosen by the state or nonprofit must be between 50 and 400 percent.

Reasons for Change

One third of all Americans have no assets available for investment, and another fifth have only negligible assets. The United States household savings rate lags far behind other industrial nations, constraining national economic growth and keeping many Americans from entering the economic mainstream by buying a house, obtaining an adequate education, or starting a business.

To ameliorate this situation by establishing IDA programs more broadly, federal support is needed both for the matching funds and for the administrative costs of the programs. In addition, financial education is an essential component of a policy to assist lower-income persons in building assets. By helping program sponsors to defray the costs associated with matching participants' contributions, administering the accounts, and providing financial education, the credit will both stimulate savings and encourage a sensible approach to lifetime financial planning.

Proposal

The Administration's proposal would create a tax credit, subject to the provisions of the General Business Credit, to defray the cost of establishing and running IDA programs, contributing matching funds to the appropriate accounts, and providing financial education to account holders. Program sponsors could be qualified financial institutions, qualified nonprofits, or qualified Indian tribes, but the accounts would have to be held by an institution eligible under current law to serve as the custodian of IRAs. The goals and broad outline of this program are similar to those of the IDA demonstration program; however, certain specific design features are intended to facilitate administration through the tax system.

Individuals between the ages of 18 and 60 who are not dependents or students and meet certain income requirements would be eligible to establish and contribute to an IDA. For single filers, the income limit would be $20,000 in modified adjusted gross income (AGI). The corresponding thresholds for head-of-household and joint filers would be $30,000 and $40,000 respectively. (Married individuals filing separately could not participate.) Modified AGI is AGI as ordinarily computed, plus certain exempt items. In all cases eligibility would be determined by the individual's circumstances for the previous taxable year. Eligibility limits would be indexed annually for inflation after the first year the credit is available. Sponsors would match contributions from eligible account holders on a dollar-for-dollar basis up to $500 per year. The main account (including earnings) and an account containing the matching amounts (including earnings) would be tracked separately by the sponsor.

Program sponsors (and, if the sponsor is exempt, other persons as provided in regulations) could claim a tax credit for an IDA program. The credit would have two components: First, a $50-per-account credit could be claimed each year to offset the ongoing costs of maintaining and administering each account and providing financial education to participants. Except for the first year that an account is open, the credit would be available only for accounts with a balance at year's end of more than $100. In addition, there is a credit for the dollar-for-dollar matching amounts.

Participants could generally withdraw their contributions and matching funds (including earnings) for qualified purposes, which include certain higher education expenses, first-time home purchase expenditures, and small business capitalization. The financial institution at which the IDA is held would generally be required to disburse the funds directly to another financial institution (in cases of home purchase or business start-up) or to an institution of higher education. Non-qualified distributions could not be made from the account containing the matching funds (including earnings). Non-qualified withdrawals from the account containing the participant's contributions could result in the forfeiture of some or all of the amounts in the matching-fund account. Matching funds and earnings would generally be available, without penalty, to the account holder for any purpose after he or she attains the age of 61.

Contributions to IDAs by individuals would not be deductible, and the earnings on the contributions would be taxable to the account holder. Matching amounts and earnings on those amounts would not be taxable to the account holder at any time.

The proposal includes explicit regulatory authority for Treasury to adopt rules to permit IDA program sponsors to verify the eligibility of individuals seeking to open accounts and to ensure that these individuals have not previously opened such an IDA. The authority would also extend to rules governing the recapture of credits claimed with respect to non-eligible individuals and with respect to matching amounts and earnings that are forfeited.

The proposed effective date allows sufficient time to establish the regulatory and operational infrastructure for IDA programs, including regulations making it practical for exempt persons to serve as program sponsors. Thus the credit could generally be claimed for taxable years ending after December 31, 2007, and beginning before January 1, 2015. The credit would apply with respect to the first 900,000 IDA accounts opened after December 31, 2007, and before January 1, 2013, and with respect to matching funds for participant contributions that are made after December 31, 2007, and before January 1, 2015.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	-134	-286	-326	-300	-1,046	-1,763

Encourage entrepreneurship and investment

INCREASE EXPENSING FOR SMALL BUSINESS

Current Law

Section 179 provides that, in place of capitalization and subsequent depreciation, certain taxpayers may elect to deduct up to $100,000 of the cost of qualifying property placed in service each taxable year. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $400,000. Both limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2008. (For taxable years beginning after December 31, 2007, the maximum deduction amount reverts back to $25,000, and the phase-out of the deductible amount begins at $200,000). More generous incentives are provided for investment in the New York Liberty Zone, in an empowerment zone or renewal community, or in the Gulf Opportunity (GO) Zone.

In general, qualifying property is defined as depreciable tangible personal property and certain depreciable real property that is purchased for use in the active conduct of a trade or business. For taxable years beginning after 2002 and before 2008, off-the-shelf computer software is considered qualifying property even though it is intangible property. An election for the section 179 deduction can be revoked on an amended return for taxable years beginning after 2002 and before 2008. In other years, elections can only be revoked with the consent of the Commissioner.

Reasons for Change

The temporary expansion of section 179 provides a number of benefits to small business taxpayers and the economy. Expensing encourages investment by lowering the after-tax cost of capital purchases, relative to claiming regular depreciation deductions. Expensing is also simpler than claiming regular depreciation deductions, which is particularly helpful for small businesses. Including off-the-shelf computer software in section 179 means that purchased software is not disadvantaged relative to developed software (for which development costs can generally be expensed). Allowing revocations of section 179 elections to be made on amended returns helps less sophisticated taxpayers, who may not always be aware of the implications of section 179 expensing when they file their initial tax return. Inflation-adjusting the specified dollar amounts ensures that the benefits of section 179 do not apply to an ever-shrinking share of business taxpayers.

A further expansion of section 179 would extend the benefits of expensing to more taxpayers and would also simplify tax accounting for them. Making the expansion permanent would allow these businesses to plan their future investments better.

Proposal

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. Both the deduction limit and phase-out threshold would be indexed annually for inflation. In addition, the proposal would allow expensing elections to be made or revoked on amended returns. The President also proposes to make the higher amounts under section 179 permanent (see page 2).

The proposal would be effective for property placed in service in taxable years beginning on or after January 1, 2007. The $200,000 and $800,000 amounts would be indexed for inflation for any taxable year beginning in a calendar year after 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-2,522	-3,527	-2,625	-2,037	-1,645	-12,356	-18,713

Invest in Health Care

FACILITATE THE GROWTH OF HSA-ELIGIBLE HEALTH COVERAGE

Current Law

Eligible individuals are allowed to accumulate funds in a Health Savings Account (HSA) on a tax-preferred basis to pay for medical expenses and retiree health coverage.

Eligibility: In order to contribute to an HSA, an individual must be covered by a high-deductible health plan (HDHP) and generally no other health plan except for certain permitted or disregarded coverage. Individuals who can be claimed as a dependent on someone else's return or who are enrolled in Medicare may not contribute to an HSA. An HSA may only be established on or after the first day of the first month that an individual is an eligible individual with HDHP coverage on the first day.

Tax Treatment of Contributions and Earnings: Employer contributions to HSAs are excluded from employee income for income and employment tax purposes. Individual contributions to HSAs are deductible in computing the individual's adjusted gross income (AGI), but are not deductible from payroll taxes. Earnings in an HSA accumulate tax-free.

Tax Treatment of Distributions: Withdrawals for qualified medical expenses of the HSA owner, the owner's spouse or dependent are not taxable. Qualified medical expenses are generally medical expenses as defined for the itemized medical expense deduction, with the addition of nonprescription drugs. However, qualified medical expenses do not include payments for insurance except in certain limited situations – a health plan during any period of continuation coverage under COBRA or other federal law; qualified long-term care insurance, a health plan while an individual is receiving unemployment compensation under Federal or State law, or individuals who have reached age 65 (other than Medicare supplemental policies). Thus, most purchases of insurance with HSA funds are included in income and subject to the 10 percent tax on non-medical withdrawals to the extent applicable. There is no limit on the time for reimbursing qualified medical expenses that are incurred after the HSA is established. Nonmedical withdrawals are subject to an additional 10 percent tax if made before age 65 and are includable in income regardless of age. Reimbursements of qualified medical expenses that are excluded from income only include medical expenses incurred after the HSA is established. Consequently, where HDHP coverage begins after the first day of the month, any expenses incurred prior to the first day of the next month may not be reimbursed by the HSA on a tax-favored basis.

HDHPs: In order to be an HDHP, a plan in 2006 must have a deductible of at least $1,050 for self-only coverage or $2,100 for family coverage. An HDHP in 2006 may not have a total out-of-pocket exposure of more than $5,250 for self-only coverage or $10,500 for family coverage. The deductible minimums and out-of-pocket maximums are indexed for inflation. The out-of-pocket amount includes the deductible as well as copays and other amounts a covered individual must pay for covered benefits. For network plans, the out-of-pocket requirement only includes the out-of-pocket amounts for benefits provided in network. Out-of-pocket expenses do not include amounts paid by covered individuals for benefits excluded by reasonable benefit restrictions or exclusions.

Contribution Limits: Annual contributions to HSAs are limited to the lesser of the deductible of the HDHP or $2,700 (for self-only coverage in 2006) or $5,450 (for family coverage in 2006.) For network plans, only the deductible for benefits provided in-network is taken into account for purposes of determining the HSA maximum contribution. Maximum contributions are based on the sum of monthly limits, with contributions pro rated for individuals who are not eligible individuals for the entire year.

A special rule applies for determining HSA contributions by married individuals with family HDHP coverage. If one spouse has family coverage, both spouses are generally treated as having family coverage. The maximum annual HSA contribution based on the family HDHP coverage is divided between the spouses equally unless they agree on a different division, which can include allocating the entire contribution to one spouse. For this purpose, family coverage is defined as anything that is not self-only coverage; thus, family HDHP coverage (supporting a family-level contribution) is health coverage that covers one eligible individual and at least one other individual, regardless of the other individual's coverage. An exception is provided for married individuals who have self-only or family HDHP coverage where his or her spouse's family non-HDHP coverage does not cover the individual (such as where the spouse has "employee plus non-spouse dependents" non-HDHP coverage.) In that case, the individual is allowed to contribute up to the HDHP deductible (or statutory limit if applicable). Where married couples have non-overlapping family coverage, however, they are not allowed to "stack" the deductibles to determine the amount of the contribution; the lowest family HDHP deductible determines the HSA contribution. A married individual with individual HDHP coverage may not make contributions to his or her spouse's HSA based on the married individual's self-only HDHP coverage.

In addition to the annual contribution, individuals who attain age 55 during the year are allowed to make an additional catch up contribution. The catch up amount increases in $100 increments from $700 in year 2006 to $1000 for 2009 and years after 2009. Catch up contributions are pro rated for the number of months that the HSA owner is an eligible individual. If both spouses qualify for the catch up contribution, both spouses are allowed the additional HSA contribution amount. However, one spouse is not permitted to have his or her catch up contribution made to the HSA owned by the other spouse.

Employer Contributions: Employer contributions to HSAs are subject to comparability rules that generally require that if the employer contributes to one employee's HSA, the employer must contribute the same amount or percentage of the HDHP deductible to all employees who are eligible individuals with comparable (i.e., self-only or family) coverage. The comparability rules do not apply to contributions made through a cafeteria plan.

HRAs: Health Reimbursement Arrangements (HRAs) are employer-sponsored plans which allow employers to reimburse substantiated employee medical expenses up to a maximum amount. Unlike a flexible spending arrangement (FSA) under section 125, unused HRA amounts may be used in later years. HRAs may not be funded by salary reduction. Employers may also provide health coverage through an FSA. HRAs are employer-provided health coverage that disqualify individuals from contributing to HSAs unless the HRA is designed to be compatible with HSA, such as being limited to reimbursing certain permitted or disregarded coverage and preventive care (limited purpose HRAs), reimbursing expenses after the deductible of the HDHP is satisfied (post-deductible HRAs), or combinations. The disqualification from HSA contributions applies regardless of whether the HRA coverage is provided by the employer of the individual or spouse of the individual.

Reasons for Change

Health care costs continue to rise rapidly in the United States. Empowering health care consumers to play a more direct role in their health care decisions, rather than third party payors, would help to stem this trend. A health care system that is more market-oriented and consumer driven will help control costs and result in health care that is more affordable and accessible.

The Federal tax code's treatment of medical care has been a fundamental factor in the development of the third party system of financing health care in the U.S. However, the tax code does not treat the self-employed, unemployed, and workers for companies that do not offer health insurance (most of whom are small businesses) the same as companies that do offer health insurance. Employer-based insurance receives a tax subsidy that individually-purchased insurance does not. In addition, insurance (employer-based) generally receives a tax subsidy, while out-of-pocket spending does not.

These large tax subsidies encourage generous health insurance and health spending that isn't fully valued, and makes our labor markets less flexible:

- Because health care purchased through an employer insurance plan is subsidized by the tax code, people insure against predictable and routine expenses (not just unpredictable, catastrophic expenses), and are thus insensitive to the cost of the health care they consume.
- The tax subsidy is generally not available to the uninsured or to individual insurance purchasers, resulting in an under-developed individual market.
- Employer contributions further mask the cost of health care to employees, whose wages tend to be lower when health care costs go up.
- Employees may be reluctant to leave their jobs for fear of losing their insurance. Portability of health insurance is increasingly important in today's dynamic labor markets where workers choose to change jobs with increasing frequency.

These tax distortions would be eliminated if employer insurance, individually-purchased insurance, and out-of-pocket health spending were on equal tax footing.

Proposal

1. Provide an above-the-line deduction and income tax credit for the purchase of HSA-eligible non-group health coverage. Individuals covered under HSA-eligible HDHPs in the individual insurance market would be allowed an above-the-line deduction for the amount of the premium in determining adjusted gross income (i.e., the taxpayer would receive a deduction regardless of whether the person itemizes deductions). An individual would not qualify for the deduction if, in addition to the high deductible plan for which the deduction is claimed, he or she is covered by other health insurance, except for health insurance that provides only certain benefits. Individuals claiming the Health Insurance Tax Credit or Health Coverage Tax Credit or covered by employer plans or public plans or otherwise not eligible to contribute to an HSA would not qualify for the deduction. Premiums deducted by self-employed individuals could not also be deducted as HDHP premiums.

In order to further level the playing field for those purchasing their own individual coverage, individuals covered under HDHPs in the individual insurance market would be allowed a refundable credit of the smaller of (1) 15.3 percent of the HDHP premium, or (2) 15.3 percent of the individual's wages subject to employment taxes. If the taxpayer has wages above the Social Security wage cap, the credit would be lower to account for the lower employment tax rate on wages above the cap. No payroll taxes would be diverted from the Social Security and Medicare Trust Funds. The deduction and credit would not be allowed for amounts paid with HSA funds.

2. Increase the amounts that can be contributed to HSAs and provide a refundable income tax credit to offset employment taxes on HSA contributions not made by an employer. The maximum annual HAS contribution would be increased to the out-of-pocket limit for a participant's HDHP. (For 2006, the statutory maximum out-of-pocket limit is $5,250 for self-only coverage or $10,500 for family coverage.) The maximum HSA contribution would be pro rated for the number of months that the individual is an eligible individual with coverage by the HDHP.

As under current law, a special rule would apply for determining HSA contributions by married individuals with family HDHP coverage. If one spouse has family coverage, both spouses are generally treated as having family coverage. If both spouses have family coverage, the coverage with the lowest bona fide out-of-pocket amount determines the maximum annual HSA contribution by the couple. The maximum annual HSA contribution based on the family HDHP coverage is divided between the spouses equally unless they agree on a different division, which can include allocating the entire contribution to one spouse. If one spouse has family coverage that is not HDHP coverage, neither spouse may contribute to an HSA unless the non-HDHP does not cover both spouses.

Where married couples have non-overlapping coverage, they would be allowed to "stack" the separate maximum contributions up to the out-of-pocket maximum allowed for a family HDHP to determine the amount of the contribution. The contributions to each spouse's HSA would remain subject to that spouse's respective HSA contribution limit. Family HDHP coverage that only covers a single eligible individual is treated as self-only coverage for purposes of determining the maximum HSA contribution. Thus, if there is only a single eligible individual covered by a family HDHP, the maximum HSA contribution is capped at the out of pocket maximum for a self-only plan. With respect to catch up contributions, if both spouses are eligible individuals, both spouses will be allowed to contribute the contributions to a single HSA owned by one spouse.

In addition, taxpayers making after-tax contributions to an HSA for the year would be allowed a refundable credit equal to a percentage of the after-tax HSA contributions to offset the employment taxes on the contribution. The credit would be the smaller of (1) 15.3 percent of the after-tax contributions to the HSA, or (2) 15.3 percent of wages subject to employment taxes. If the taxpayer has wages above the Social Security wage cap, the credit would be lower to account for the lower employment tax rate on wages above the cap. If the taxpayer is also eligible for a credit based on after-tax HDHP premium payments, the OASDI portion of the employment tax in the above calculation would be limited by the combined amount by which the after-tax HDHP premium payments and after-tax HSA contributions exceed the amount of wages above the OASDI cap. In order to recapture the credit relating to employment taxes for contributions that are not used for medical expenses, the additional tax on nonmedical distributions would be increased to 30 percent, with a 15 percent rate on nonmedical distributions after death, disability or attaining the age for Medicare eligibility (65).

3. Provide a refundable tax credit to lower income individuals for the purchase of HSA-eligible health coverage. A refundable health insurance tax credit (HITC) would be provided for the cost of an HSA-eligible high-deductible health plan purchased by individuals under age 65. The credit would provide a subsidy of up to 90 percent of the health insurance premium, up to a maximum dollar amount described below. The maximum subsidy percentage of 90 percent would apply for low-income taxpayers and would be phased down at higher incomes. Individuals participating in public or employer-provided health plans would generally not be eligible for the tax credit.

Individuals would not be allowed to claim the HITC for the same period they claim the Health Coverage Tax Credit. In addition, individuals would not be allowed to claim the HITC for the same period they claim an above-the line deduction for their premiums.

Individuals with no dependents who file a single return and have modified AGI up to $15,000 would be eligible for the maximum subsidy rate of 90 percent of the premium (up to $1,111) of the individual's coverage and a maximum tax credit of $1,000. The subsidy percentage for these individuals would be phased down ratably from 90 percent to 50 percent between $15,000 and $20,000 of modified AGI, and then phased out completely at $30,000 of modified AGI. Thus, for example, a single individual with a $20,000 modified AGI would be entitled to a credit of $556 (.50 x $1111).

Other filers with modified AGI up to $25,000 would be eligible for the maximum subsidy rates and the following credit maximums:

(1) 90 percent of $1,111, or $1,000, for a policy covering only one adult, only one child, or only two or more children,
(2) 90 percent of $2,222, or $2,000, for a policy or policies covering two adults or one adult and one or more children, and
(3) 90 percent of $3,333, or $3,000, for a policy or policies covering two adults plus one or more children.

The maximum dollar amounts would be indexed by the medical care component of the Consumer Price Index based on all urban consumers. The subsidy percentage for non-single taxpayers would be phased out ratably between $25,000 and $40,000 of modified AGI in the case of a policy covering only one adult or only one child, and between $25,000 and $60,000 of modified AGI in the case of a policy or policies covering more than one person.

Individuals could claim the HITC for health insurance premiums paid as part of the normal tax-filing process. Alternatively, beginning in 2008, the tax credit would be available in advance at the time the insurance is purchased. Individuals would reduce their premium payment by the amount of the credit and the health insurer would be reimbursed by the Department of the Treasury for the amount of the advance credit. Eligibility for the advance credit would be based on the individual's prior year tax return.

In addition to the non-group insurance market, qualifying health insurance could also be purchased through private purchasing groups, state-sponsored insurance purchasing pools and state high-risk pools. Also, at state option, effective after December 31, 2007, the tax credit would be allowed for certain individuals not otherwise eligible for public health insurance programs to buy into privately contracted state sponsored purchasing groups (such as Medicaid or SCHIP purchasing pools for private insurance or state government employee programs for states in which Medicaid or SCHIP does not contract with private plans.) States could, under limited circumstances, provide additional contributions to individuals who purchased private insurance through such purchasing groups. The maximum state contribution would be $2,000 per adult for up to two adults for individuals with incomes up to 133 percent of poverty. The maximum state contribution would phase down ratably reaching $500 per adult at 200 percent of poverty. Individuals with income above 200 percent of poverty would not be eligible for a state contribution. States would not be allowed to provide any other explicit or implicit cross subsidies.

4. Make other statutory changes to facilitate the formation and administration of HSAs. For HSA purposes, qualified medical expenses would include any medical expense incurred on or after the first day of HSA-eligible coverage for a year. The reimbursement of the expenses by an HSA established no later than the date for filing the return for that taxable year (not including extension) would be excluded from income.

Qualified medical expenses that can be reimbursed by an HSA would be expanded to include the premiums for the purchase of non-group HSA-eligible plans.

Employers would be allowed to contribute existing HRA balances to the HSAs of employees who would be eligible individuals but for the HRA coverage. The contributions of the HRA balances would not be taken into account for purposes of the comparability rules, or the annual maximum HSA contributions. Only HRAs existing on the date of enactment would qualify for the transfer and only contributions of HRA balances made in prior taxable years beginning one year after the date of enactment would be covered.

Contributions to HSAs on behalf of employees who are chronically ill or employees who have spouses or dependents who are chronically ill would be excluded from the comparability rules to the extent the contributions exceed the comparable contributions for other employees.

All of the changes described above would apply for tax years beginning after December 31, 2006.

Revenue Estimates

	Fiscal Years[5]							
	2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
	($ in millions)							
1. Above-the-line deduction and refundable tax credit for HSA-eligible coverage[6]	--	-2,763	-4,130	-4,159	-3,994	-3,973	-19,019	-41,327
2. Increase maximum HSA contribution limit and refundable tax credit[7]	--	-2,054	-4,455	-6,404	-7,974	-9,115	-30,002	-90,084
3. Refundable tax credit for purchase of HSA-eligible coverage[8]	--	-635	-1,608	-2,289	-2,653	-2,705	-9,890	-24,093
4. Make other statutory changes to facilitate the formation and administration of HSAs	--	-15	-44	-50	-56	-63	-228	-628
Total	--	-5,467	-10,237	-12,902	-14,677	-15,856	-59,139	-156,132

[5] Because there are interactions among the proposals, the revenue estimates for each of the four health care proposals shown above depend on the order in which they are estimated and have been estimated in the order shown. The total revenue estimate for the four proposals taken together is unaffected by the ordering.
[6] Includes both receipt and outlay effects. The outlays effect is $3,200 million for FY 2007-20016.
[7] Includes both receipt and outlay effects. The outlays effect is $3,500 million for FY 2007-20016.
[8] Includes both receipt and outlay effects. The outlays effect is $12,939 million for FY 2007-20016.

IMPROVE THE HEALTH COVERAGE TAX CREDIT

Current Law

The Health Coverage Tax Credit (HCTC) was created under the Trade Adjustment Assistance (TAA) Reform Act of 2002 for the purchase of qualified health insurance for eligible individuals and for their family members. The HCTC is refundable and equal to 65 percent of the cost of qualified health insurance paid by eligible individuals, including certain recipients of the TAA or Alternative TAA (ATAA) benefits and certain individuals between the ages of 55 and 64 who are receiving pension benefits from the Pension Benefit Guaranty Corporation (PBGC). Individuals can claim the HCTC as part of the tax-filing process or through an advance payment program at the time qualified insurance is purchased. The HCTC is not available (either for the eligible individual or the eligible individual's family) once the eligible individual becomes entitled to Medicare coverage.

Since 1997, the Health Insurance Portability and Accountability Act (HIPAA) has provided protections for individuals who have 12 months of creditable coverage (generally continuous health coverage without a gap of more than 63 days). To be a qualified state-based HCTC plan, however, a plan must provide protections similar to the HIPAA protections for individuals who have only 3 months of creditable coverage.

Reasons for Change

Making the requirements for qualified state-based coverage under the HCTC more consistent with the HIPAA rules encourages plans to participate in the HCTC program. Also, there are many cases in which the eligible individual is (or becomes) entitled to Medicare coverage but has a spouse who is younger. In these cases, the younger spouse is not entitled to the credit, even though the younger spouse would be entitled to the credit if he or she were receiving benefit checks from the PBGC (as a survivor or divorcee). Finally, a number of issues should be clarified in order to facilitate the administration of the HCTC.

Proposal

First, the proposal would subject state-based HCTC coverage to rules more like the HIPAA rules by allowing state-based coverage to impose a pre-existing condition restriction for a period of up to 12 months, provided the plan reduces the restriction period by the length of the eligible individual's creditable coverage (as of the date they apply for the state-based coverage). This provision would be effective for eligible individuals applying for coverage after December 31, 2006. Second, effective for taxable years beginning after December 31, 2006, the proposal would permit spouses of HCTC-eligible individuals to claim the HCTC when the HCTC-eligible individual becomes entitled to Medicare coverage. The spouse, however, would have to be at least 55 years old and meet the other HCTC eligibility requirements. Third, the proposal would provide the following clarifications:

(1) Clarify that individuals who elect to receive one-time lump sum payments from the PBGC and certain alternative PBGC payees would be eligible for the HCTC.

(2) For purposes of the state-based coverage rules, deem the Commonwealths of Puerto Rico and the Northern Mariana Islands as well as American Samoa, Guam, and the U.S. Virgin Islands to be states.
(3) Clarify that state continuation coverage provided under a state law would automatically qualify as "qualified health insurance," as federally mandated COBRA continuation coverage, without meeting the requirements relating to state-based qualified coverage.
(4) Apply the same list of "other specified coverage" to all eligible individuals by changing the definition of "other specified coverage" for "eligible ATAA recipients" to conform to the definition applied to other eligible individuals.

Revenue Estimate[9]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-5	-13	-16	-19	-20	-73	-190

[9] The estimate includes both receipt and outlay effects. The outlay effect is $139 million for 2007-2016.

ALLOW THE ORPHAN DRUG TAX CREDIT FOR CERTAIN PRE-DESIGNATION EXPENSES

Current Law

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States (orphan drug credit). Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration (FDA) in accordance with the section 526 of the Federal Food, Drug, and Cosmetic Act. Research expenses claimed for the orphan drug credit are not eligible for the credit for increasing research under section 41 of the Internal Revenue Code.

Reasons for Change

Currently, expenditures for human clinical trials are eligible for the credit only after the FDA designates the drug as a potential treatment for a rare disease or condition. Expenses for clinical trials that the taxpayer undertakes while the FDA reviews the taxpayer's application for designation are ineligible. This creates an incentive to defer clinical testing for orphan drugs until the taxpayer receives the FDA's approval and complexity for taxpayers by treating pre-designation and post-designation clinical expenses differently. The proposal would reduce the incentive to defer clinical testing while the FDA reviews the taxpayer's application for designation of a drug as an orphan drug and simplify the credit by treating pre-designation expenses and post-designation expenses equally.

Proposal

Taxpayers that incur expenses prior to FDA designation would be permitted to claim the orphan drug credit for these expenses if the drug receives FDA designation as a potential treatment for a rare disease or condition before the due date (including extensions) for filing the tax return for the year in which the FDA application was filed.

The proposal would be effective for qualified expenses incurred after December 31, 2005.

Revenue Estimate

[No revenue effect]

Provide Incentives for Charitable Giving

PERMIT TAX-FREE WITHDRAWALS FROM IRAS FOR CHARITABLE CONTRIBUTIONS

Current Law

Eligible individuals may make deductible contributions to a traditional individual retirement arrangement (traditional IRA). Other individuals with taxable income may make nondeductible contributions to a traditional IRA. Earnings and pre-tax contributions in a traditional IRA are includible in income when withdrawn. Withdrawals made before age 59½ are subject to an additional 10-percent excise tax, unless an exception applies.

Individuals with adjusted gross incomes (AGI) below certain levels may make nondeductible contributions to a Roth IRA. Amounts withdrawn from a Roth IRA as a qualified distribution are not includible in income. A qualified distribution is a distribution made (1) after 5 years and (2) after the holder has attained age 59½, died, or become disabled or is made for first-time homebuyer expenses of up to $10,000. Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent the distributions are attributable to earnings, and are also subject to the 10-percent early withdrawal tax (unless an exception applies).

Individuals who itemize their deductions may claim a deduction for contributions made to qualified charitable organizations. Total deductible contributions may not exceed 50 percent of the taxpayer's AGI, and lower deductibility limits apply in the case of contributions of appreciated property and contributions to certain private foundations. Excess amounts may be carried forward and deducted in future years. In addition, the total of most categories of itemized deductions, including charitable contributions, is reduced by 3 percent of AGI in excess of a certain threshold ($150,500 for joint filers in 2006).

Reasons for Change

Under current law, a taxpayer who wishes to donate otherwise taxable IRA assets to charity must first include the taxable amounts in income and then claim a deduction for charitable contributions. Because not all taxpayers can deduct the full amount of their charitable contributions, current law effectively discourages some taxpayers from contributing their IRA assets to charity. Allowing taxpayers to exclude from income direct transfers from IRAs to qualified charities will stimulate additional charitable giving by simplifying the required tax calculations and eliminating the current-law tax disincentives.

Proposal

Individuals would be allowed to exclude from gross income (and thus from AGI for all purposes under the Code) distributions made after age 65 from a traditional or Roth IRA directly to a qualified charitable organization. The exclusion would not apply to indirect gifts through a split interest entity such as a charitable remainder trust or pooled income fund, or through the purchase of a charitable gift annuity. The exclusion would be available without regard to the percentage of AGI limits that apply to deductible contributions. An amount transferred directly to a charitable organization would be counted as a distribution for purposes of the required minimum distribution rules. The exclusion for transfers to charitable organizations would apply only to the extent the individual does not receive any benefit in exchange for the transfer. No charitable deduction would be allowed with respect to any amount that is excludable from income under this provision. If an amount transferred from the IRA would otherwise be nontaxable, such as a qualified distribution from a Roth IRA or the return of nondeductible contributions from a traditional IRA, the normal charitable contribution deduction rules would apply.

The proposal would be effective for distributions made after the date of enactment.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-102	-510	-512	-501	-497	-2,122	-4,706

EXPAND AND INCREASE THE ENHANCED CHARITABLE DEDUCTION FOR CONTRIBUTIONS OF FOOD INVENTORY

Current Law

A taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory. However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) the taxpayer's basis in the contributed property, plus one-half of the gain that would have been realized had the property been sold or (2) two times basis. To be eligible for the enhanced deduction, the inventory must be contributed to a charitable organization (other than a private nonoperating foundation), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with these requirements. To claim the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

Reasons for Change

The lack of incentives for businesses other than C corporations (including many farmers and small businesses) to donate food inventory to charity reduces the ability of charities to combat hunger. Increasing the amount of the enhanced deduction for contributions of food inventory, making it available to any taxpayer engaged in a trade or business, and clarifying the method of determining fair market value in the case of surplus food will increase donations of food inventory.

Proposal

Eligibility for the enhanced deduction for donations of food inventory would be expanded to include businesses other than C corporations. The amount of the enhanced deduction for donations of food inventory would be increased to the lesser of: (1) fair market value, or (2) two times basis. To ensure consistent treatment of all businesses claiming an enhanced deduction for donations of food inventory, the enhanced deduction for qualified food donations by S corporations and non-corporate taxpayers would be limited to 10 percent of net income from the associated trade or business. A special provision would allow taxpayers with a zero or low basis in the qualified food donation (e.g., taxpayers that use the cash method of accounting for purchases and sales, and taxpayers that are not required to capitalize indirect costs) to assume a basis equal to 25 percent of fair market value. The enhanced deduction would be available only for donations of "apparently wholesome food" (food intended for human consumption that meets all quality and labeling standards imposed by federal, State, and local laws and regulations, even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions). The fair market value of "apparently wholesome food" that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market, would be determined by taking into account the price at which the same or substantially the same food items (taking into account both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

These proposed changes in the enhanced deduction for donations of food inventory would be effective for taxable years beginning after December 31, 2005.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-44	-96	-106	-116	-127	-489	-1,345

REFORM EXCISE TAX BASED ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS

Current Law

Private foundations that are exempt from federal income tax generally are subject to a two-percent excise tax on their net investment income. The excise tax rate is reduced to one percent in any year in which the foundation's distributions for charitable purposes exceed the average level of the foundation's charitable distributions over the five preceding taxable years (with certain adjustments). Private foundations that are not exempt from federal income tax, including certain charitable trusts, must pay an excise tax equal to the excess (if any) of the sum of the excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. Under current law, private nonoperating foundations generally are required to make annual distributions for charitable purposes equal to at least five percent of the fair market value of the foundation's noncharitable use assets (with certain adjustments). The amount that a foundation is required to distribute annually for charitable purposes is reduced by the amount of the excise tax paid by the foundation.

Reasons for Change

The current "two-tier" structure of the excise tax on private foundation net investment income may discourage foundations from significantly increasing their distributions for charitable purposes in any particular year. Under the current formula, any increase in the foundation's percentage payout in a given year (by increasing the average percentage payout) makes it more difficult for the foundation to qualify for the reduced one percent excise tax rate in subsequent years. Eliminating the "two-tier" structure of this excise tax would ensure that private foundations do not suffer adverse excise tax consequences if they increase their grantmaking in a particular year to respond to charitable needs. Such a change would also simplify tax planning and the calculation of the excise tax for private foundations. In addition, lowering the excise tax rate for all foundations would make additional funds available for charitable purposes.

Proposal

This proposal would replace the two rates of tax on private foundations that are exempt from federal income tax with a single tax rate of one percent. The tax on private foundations not exempt from federal income tax would be equal to the excess (if any) of the sum of the one-percent excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic level of charitable distributions would be repealed.

The proposal would be effective for taxable years beginning after December 31, 2005.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-56	-85	-90	-96	-102	-429	-1,074

MODIFY TAX ON UNRELATED BUSINESS TAXABLE INCOME OF CHARITABLE REMAINDER TRUSTS

Current law

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a non-charity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Distributions from a charitable remainder trust, which are included in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed, are treated in the following order as: (1) ordinary income to the extent of the trust's undistributed ordinary income for that year and all prior years; (2) capital gains to the extent of the trust's undistributed capital gain for that year and all prior years; (3) other income to the extent of the trust's undistributed other income for that year and all prior years; and (4) corpus (trust principal).

Charitable remainder trusts are exempt from federal income tax. However, charitable remainder trusts lose their income tax exemption for any year in which they have unrelated business taxable income. Any taxes imposed on the trust are required to be allocated to trust corpus.

Reasons for Change

Under current law, a charitable remainder trust that has any unrelated business taxable income loses its tax-exempt status for the year. The Administration believes that imposing a tax equal to 100 percent of any unrelated business taxable income received by a charitable remainder trust is a more appropriate remedy than loss of tax exemption for the year.

Proposal

The Administration proposes to levy a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust, in lieu of depriving the trust of its federal income tax exemption for any year in which unrelated business taxable income is received. The unrelated business taxable income would be considered income of the trust for purposes of determining the character of the distribution made to the beneficiary. The amount of the tax would be allocated to corpus.

The proposal would be effective for taxable years beginning after December 31, 2005, regardless of when the trust was created.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-1	-6	-6	-6	-6	-25	-62

MODIFY BASIS ADJUSTMENT TO STOCK OF S CORPORATIONS CONTRIBUTING APPRECIATED PROPERTY

Current Law

If an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining income tax liability. A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder. In many cases, a shareholder's basis in S corporation stock reflects the basis of the contributed property, whereas the charitable contribution deduction reflects the value of the contributed property. As a result, current law deprives some S corporation shareholders from obtaining the full benefit of the charitable contribution deduction.

Reasons for Change

The proposal modifies the rules for adjusting the basis of S corporation stock to preserve the benefit of providing a charitable contribution deduction for contributions of appreciated property by an S corporation.

Proposal

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

The proposal would be effective for taxable years beginning after December 31, 2005.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-3	-15	-21	-25	-28	-92	-301

REPEAL THE $150 MILLION LIMITATION ON QUALIFIED 501(C)(3) BONDS

Current Law

The Tax Reform Act of 1986 established a $150 million limit on the volume of outstanding, non-hospital, tax-exempt bonds for the benefit of any one 501(c)(3) organization. The provision was repealed in 1997 with respect to bonds issued after August 5, 1997, at least 95 percent of the net proceeds of which are used to finance capital expenditures incurred after that date. Thus, the limitation continues to apply to bonds more than five percent of the net proceeds of which finance or refinance (1) working capital expenditures or (2) capital expenditures incurred on or before August 5, 1997.

Reasons for Change

The $150 million limitation results in complexity and provides disparate treatment depending on the nature and timing of bond-financed expenditures. Issuers must determine whether an issue consists of non-hospital bonds, and must calculate the amount of non-hospital bonds that are allocable to a particular tax-exempt organization. In addition, issuers must determine whether more than five percent of the net proceeds of each issue of non-hospital bonds finances working capital expenditures, or capital expenditures incurred on or before August 5, 1997, in order to determine whether the issue is subject to the limitation. Complete repeal of the limitation would enable private universities to utilize tax-exempt financing on a basis comparable to public universities.

Proposal

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 in its entirety, effective for bonds issued after the date of enactment.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-2	-3	-6	-10	-11	-32	-81

REPEAL CERTAIN RESTRICTIONS ON THE USE OF QUALIFIED 501(C)(3) BONDS FOR RESIDENTIAL RENTAL PROPERTY

Current Law

Interest on state or local bonds is generally excluded from gross income. However, this exclusion does not apply to private activity bonds unless a specific exemption is provided in the Code.

One type of tax-exempt private activity bond is a qualified 501(c)(3) bond. In general, an issue consists of qualified 501(c)(3) bonds if, among other things, at least 95 percent of its net proceeds are used by no person other than a 501(c)(3) organization or a state or local governmental unit. For this purpose, any activity of a 501(c)(3) organization that constitutes an unrelated trade or business is a non-qualifying use.

Current law contains a special limitation (the residential rental property limitation) under which, in general, an issue does not consist of qualified 501(c)(3) bonds if any of its net proceeds are used to provide residential rental property for family units. However, this limitation does not apply if: (1) the first use of the financed property is pursuant to the issue; (2) the property meets the low-income set-aside requirements described below for qualified residential rental projects under the exempt facility bond rules; or (3) the property is substantially rehabilitated (i.e., in general, rehabilitation expenditures must equal or exceed the owner’s adjusted basis in the property) during the two-year period ending one year after the acquisition.

In addition to qualified 501(c)(3) bonds, current law authorizes the issuance of tax-exempt private activity bonds for certain exempt facilities that are owned or operated by private, for-profit entities. One type of exempt facility is a qualified residential rental project. A qualified residential rental project is a project for residential rental property if, at all times during a specified project period, the project meets one of the following requirements elected by the issuer: (1) at least 20 percent of the residential units are occupied by individuals whose income is 50 percent or less of area median gross income; or (2) at least 40 percent of the residential units are occupied by individuals whose income is 60 percent or less of area median gross income.

Reasons for Change

The residential rental property limitation results in complexity, and provides disparate treatment for new and existing property used by 501(c)(3) organizations. In applying the residential rental property limitation, issuers must first determine whether existing property is residential rental property. For example, an assisted living facility may or may not constitute residential rental property, depending in part on the amount of nursing services provided. Issuers must also determine whether existing property satisfies the low-income set-aside or rehabilitation requirements. Failure to meet the requirements could result in a loss of tax-exemption on the bonds, retroactive to the date of issue. Simplification would be achieved if the residential rental property limitation were repealed.

Proposal

The residential rental property limitation would be repealed, effective for bonds issued after the date of enactment. As under current law, the use of residential rental property by a 501(c)(3) organization would be a qualifying use only to the extent it did not constitute an unrelated trade or business.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-2	-5	-9	-16	-24	-56	-278

Strengthen Education

EXTEND THE ABOVE-THE-LINE DEDUCTION FOR QUALIFIED OUT-OF-POCKET CLASSROOM EXPENSES

Current Law

Individual taxpayers who itemize their deductions may claim a deduction for unreimbursed, job-related expenses to the extent those expenses and other miscellaneous deductions exceed 2 percent of adjusted gross income. Such deductions may not be allowed for purposes of the alternative minimum tax.

For taxable years 2002, 2003, 2004 or 2005, taxpayers who are K-12 teachers and certain other school personnel in a school for at least 900 hours during a school year may deduct, whether or not they itemize, up to $250 paid or incurred in connection with books, supplies, computer equipment and other equipment and supplemental materials used in the classroom.

Reasons for Change

Teachers and other school personnel often incur expenses related to classroom activities that are not reimbursed. These expenditures enhance the quality of education received by students but diminish a teacher's properly-measured ability to pay taxes. Allowing school personnel to deduct such expenditures on their federal income tax return encourages dedicated personnel who supplement available school resources at their own expense.

Proposal

The Administration proposes to extend this provision to apply to expenses incurred in taxable years beginning after December 31, 2005.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-17	-171	-178	-180	-183	-185	-897	-1,867

Provide Assistance to Distressed Areas

ESTABLISH OPPORTUNITY ZONES

Current Law

The Internal Revenue Code contains various incentives to encourage the development of economically distressed areas, including incentives for businesses located in empowerment zones, enterprise communities and renewal communities, the new markets tax credit, the work opportunity tax credit and the welfare-to-work tax credit.

Empowerment Zones

There are currently 40 empowerment zones—30 in urban areas and 10 in rural areas—that have been designated through a competitive application process. State and local governments nominated distressed geographic areas, which were selected on the strength of their strategic plans for economic and social revitalization. The urban areas were designated by the Secretary of the Department of Housing and Urban Development. The rural areas were designated by the Secretary of the Department of Agriculture. Designations of empowerment zones will remain in effect until December 31, 2009.

Incentives for businesses in empowerment zones include (1) a 20-percent wage credit for qualifying wages, (2) additional expensing for qualified zone property, (3) tax-exempt financing for certain qualifying zone facilities, (4) deferral of capital gains on sales and reinvestment in empowerment zone assets, and (5) exclusion of 60 percent (rather than 50 percent) of the gain on the sale of qualified small business stock held more than 5 years.

The wage credit provides a 20 percent subsidy on the first $15,000 of annual wages paid to residents of empowerment zones by businesses located in these communities, if substantially all of the employee's services are performed within the zone. The credit is not available for wages taken into account in determining the work opportunity tax credit.

Enterprise zone businesses are allowed to expense the cost of certain qualified zone property (which, among other requirements, must be used in the active conduct of a qualified business in an empowerment zone) up to an additional $35,000 above the amounts generally available under section 179.[10] In addition, only 50 percent of the cost of such qualified zone property counts toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

Qualified enterprise zone businesses are eligible to apply for tax-exempt financing (empowerment zone facility bonds) for qualified zone property. These empowerment zone facility bonds do not count against state private activity bond limits, instead a limit is placed upon each zone, depending on population and whether the zone is in an urban or rural area.

[10] Section 179 provides that, in place of depreciation, certain taxpayers, typically small businesses, may elect to deduct up to $100,000 of the cost of section 179 property placed in service each year. In general, section 179 property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Enterprise Communities

Current law authorized the designation of 95 enterprise communities, 65 in urban areas and 30 in rural areas. Qualified businesses in these communities were entitled to similar favorable tax-exempt financing benefits as those in empowerment zones. Designations of enterprise communities were made in 1994 and remained in effect through 2004. Many enterprise communities have since been re-designated as part of an empowerment zone or a renewal community.

Renewal Communities

The Community Renewal Tax Relief Act of 2000 authorized 40 renewal communities, at least 12 of which must be in rural areas. Forty renewal communities have been chosen through a competitive application process similar to that used for empowerment zones. The 40 communities were designated by the Department of Housing and Urban Development in 2002 and that designation continues through 2009.

Renewal community tax benefits include: (1) a 15-percent wage credit for qualifying wages; (2) additional section 179 expensing for qualified renewal property; (3) a commercial revitalization deduction; and (4) an exclusion for capital gains on qualified community assets held more than five years.

The wage credit and increased section 179 expensing operate in a similar fashion as in empowerment zones. The primary difference is that the wage credit is smaller, equal to 15 percent for the first $10,000 of wages.

The commercial revitalization deduction applies to certain nonresidential real property or other property functionally related to nonresidential real property. A taxpayer may elect to either: (1) deduct one-half of any qualified revitalization expenditures that would otherwise be capitalized for any qualified revitalization building in the tax year the building is placed in service; or (2) amortize all such expenditures ratably over a 120-month period beginning with the month the building is placed in service. A qualified revitalization building is any nonresidential building and its structural components placed in service by the taxpayer in a renewal community. If the building is new, the original use of the building must begin with the taxpayer. If the building is not new, the taxpayer must substantially rehabilitate the building and then place it in service. The total amount of qualified revitalization expenditures for any building cannot be more than the smaller of $10 million or the amount allocated to the building by the commercial revitalization agency for the state in which the building is located. A $12 million cap on allowed commercial revitalization expenditures is placed on each renewal community annually.

New Markets Tax Credit

The new markets tax credit provides a tax credit to investors who make “qualified equity investments” in privately-managed investment vehicles called “community development entities,” or “CDEs.” The CDEs must apply for and receive an allocation of tax credit authority from the Treasury Department and must use substantially all of the proceeds of the qualified equity investments to make qualified low-income community investments. One type of qualified low-income community investment is an investment in a qualified active low-income community business. In general, a "qualified active low-income community business" is any corporation (including a nonprofit corporation), partnership or proprietorship that meets the following requirements:

(1) At least 50 percent of the gross income of the business is derived from the active conduct of a qualified business within a low-income community (as defined in section 45D(e)). For this purpose, a "qualified business" generally does not include (1) the rental of real property other than substantially improved nonresidential property; (2) the development or holding of intangibles for sale or license; (3) the operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or a liquor store; or (4) farming if the value of the taxpayer's assets used in the business exceeds $500,000.

(2) At least 40 percent of the use of the tangible property of the business is within a low-income community.

(3) At least 40 percent of the services performed for the business by its employees are performed in a low-income community.

(4) Collectibles (other than collectibles held primarily for sale to customers in the ordinary course of business) constitute less than five percent of the assets of the business.

(5) Nonqualified financial property (which includes debt instruments with a term in excess of 18 months) comprises less than five percent of the assets of the business.

A portion of a business may be tested separately for qualification as a qualified active low-income community business.

Work Opportunity and Welfare-to-Work Tax Credits

As described under the proposal, "COMBINED WORK OPPORTUNITY / WELFARE-TO-WORK TAX CREDIT," on pages 132 to 134, employers may be entitled to a work opportunity tax credit or a welfare-to-work tax credit for certain wages paid to eligible employees.

Reasons for Change

A number of America's neighborhoods have lost a significant portion of their economic base as a result of our changing economy, for example, due to loss of manufacturing or textile employment, and are now in the process of transitioning to a more diverse, broad-based, 21st century economy. Opportunity zones would ease that transition by targeting federal resources and encouraging new and existing businesses to invest in these areas.

Proposal

Twenty opportunity zones—14 urban and 6 rural—would be created. The zone designation and corresponding incentives for these 20 zones would be in effect from January 1, 2007, to December 31, 2016. As described below, the tax incentives applicable to opportunity zones would include: (1) an exclusion of 25 percent of taxable income for opportunity zone businesses with average annual gross receipts of $5 million or less; (2) additional section 179 expensing for opportunity zone businesses; (3) a commercial revitalization deduction; and (4) a wage credit for businesses that employ opportunity zone residents within the zone.

Selection of Opportunity Zones

The Secretary of Commerce would select opportunity zones through a competitive process. A county, city or other general purpose political subdivision of a state (a "local government") would be eligible to nominate an area for opportunity zone status if the local government was designated by the Secretary of Commerce as a "Community in Transition." Two or more contiguous local governments designated as Communities in Transition could submit a joint application.

A local government could be designated as a Community in Transition if has experienced the following: (1) a loss of at least three percent of its manufacturing establishments from 1993 to 2003 (urban areas must have had at least 100 manufacturing establishments in 1993); (2) a loss of at least three percent of its retail establishments from 1993 to 2003; and (3) a loss of at least 20 percent of its manufacturing jobs from 1993 to 2003.

Local governments not making the original Community in Transition list could appeal to the Secretary of Commerce. Other factors demonstrating a loss of economic base within the local government could be considered in the appeal.

Applicants for opportunity zone status would have to develop and submit a "Community Transition Plan" and a "Statement of Economic Transition." The Community Transition Plan would have to set concrete, measurable goals for reducing local regulatory and tax barriers to construction, residential development and business creation. Communities that have already worked to address these issues would receive credit for recent improvements. The Statement of Economic Transition would have to demonstrate that the local community's economic base is in transition, as indicated by a declining job base and labor force, and other measures, during the past decade.

In evaluating applications, the Secretary of Commerce could consider other factors, including: (1) changes in unemployment rates, poverty rates, household income, homeownership and labor force participation; (2) the educational attainment and average age of the population; and (3) for urban areas, the number of mass layoffs occurring in the area's vicinity over the previous decade.

The majority of a nominated area would have to be located within the boundary of one or more local governments designated as a Community in Transition. A nominated area would have to have a continuous boundary (that is, an area must be a single area; it cannot be comprised of two or more separate areas) and could not exceed 20 square miles if an urban area or 1,000 square miles if a rural area.

A nominated urban area would have to include a portion of at least one local government jurisdiction with a population of at least 50,000. The population of a nominated urban area could not exceed the lesser of: (1) 200,000; or (2) the greater of 50,000 or ten percent of the population of the most populous city in the nominated area. A nominated rural area would have to have a population of at least 1,000 and no more than 30,000.

"Rural area" would be defined as any area that is (1) outside of a metropolitan statistical area (within the meaning of section 143(k)(2)(B)) or (2) determined by the Secretary of Commerce, after consultation with the Secretary of Agriculture, to be a rural area. "Urban area" would be defined as any area that is not a rural area.

Empowerment zones and renewal communities would be eligible to apply for opportunity zone status, but would be required to relinquish their current status and benefits once selected. Opportunity zone benefits for converted empowerment zones and renewal communities would expire on December 31, 2009. The selection of empowerment zones or renewal communities to convert to opportunity zones would be based on the same criteria that apply to other communities, but would not count against the limitation of 20 new opportunity zones.

Previously designated enterprise communities would also be eligible to apply for opportunity zone status. Aside from automatically being eligible to apply, enterprise communities would be treated as other areas that do not belong to either an empowerment zone or a renewal community once selected: benefits would be in effect for 10 years and the selection of an enterprise community as an opportunity zone would count against the limit of 20 new opportunity zones.

Reporting requirements identifying construction, residential development, job creation, and other positive economic results would apply to opportunity zones.

<u>Tax Incentives Applicable to Opportunity Zones</u>

Exclusion of 25 percent of taxable income for certain opportunity zone businesses. A business would be allowed to exclude 25 percent of its taxable income if (1) it qualified as an "opportunity zone business" and (2) it satisfied a $5 million gross receipts test.

The definition of an opportunity zone business would be based on the definition of a "qualified active low-income community business" for purposes of the new markets tax credit, treating opportunity zones as low-income communities. However, a nonprofit corporation would not qualify for treatment as an opportunity zone business. In addition, a portion of a business could not be tested separately for qualification as an opportunity zone business.

The $5 million gross receipts test would be satisfied if the average annual gross receipts of the business for the three-taxable-year period ending with the prior taxable year did not exceed $5 million. Rules similar to the rules of section 448(c) would apply.

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 the amounts generally available under section 179. In addition, only 50 percent of the cost of such qualified zone property would count toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

Commercial revitalization deduction. A commercial revitalization deduction would be available for opportunity zones in a manner similar to the deduction for renewal communities. A $12 million annual cap on these deductions would apply to each opportunity zone.

Wage credit. Individuals who live and work in an opportunity zone would constitute a new target group with respect to wages earned within the zone under a combined work opportunity tax credit and welfare-to-work tax credit, as proposed under "COMBINED WORK OPPORTUNITY / WELFARE-TO-WORK TAX CREDIT," on pages 132 to 134.

Other Benefits for Opportunity Zones

Individuals, organizations, and governments within an opportunity zone would receive priority designation when applying for new markets tax credits and the following other federal programs: 21st Century After-school, Early Reading First, and Striving Readers funding; Community Based Job Training Grants; Community Development Block Grants, Economic Development Administration grants, and HOME Funding; and USDA Telecommunications Loans, Distance Learning and Telemedicine grants, and Broadband loans.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	-221	-411	-439	-451	-482	-2,004	-4,960

Protect the Environment

EXTEND PERMANENTLY EXPENSING OF BROWNFIELDS REMEDIATION COSTS

Current Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement of hazardous substances at a qualified contaminated site (so-called "brownfields"). This provision applies only to expenditures paid or incurred before January 1, 2006.

Hazardous substances are defined generally for purposes of the brownfields provision by reference to sections 101(14) and 102 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA). A qualified contaminated site generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) contains (or potentially contains) a hazardous substance; and (3) is certified by the appropriate state environmental agency as to the presence (or potential presence) of a hazardous substance. However, sites that are identified on the national priorities list under CERCLA do not qualify as qualified contaminated sites.

The Gulf Opportunity Zone Act of 2005 extended the expensing of environmental remediation expenditures for two years (through December 31, 2007) for qualified contaminated sites located within the Gulf Opportunity (GO) Zone. Also, expensing was permitted for expenditures paid or incurred on or after August 28, 2005, and before January 1, 2008, to abate contamination from petroleum (as defined in section 4612(a)(3)) at sites within the GO Zone.

Reasons for Change

The Administration believes that encouraging environmental remediation is an important national goal. The brownfields provision encourages the cleanup of contaminated brownfields, thereby enabling them to be brought back into productive use in the economy and mitigating potential harms to public health. Extending the special treatment accorded to brownfields on a permanent basis would remove doubt among taxpayers as to the deductibility of remediation expenditures and would promote the goal of encouraging environmental remediation.

Proposal

The expensing of brownfield remediation expenditures would be made permanent by eliminating the restriction that qualified expenditures must be paid or incurred before January 1, 2006.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-98	-146	-163	-177	-168	-157	-811	-1,503

Restructure Assistance to New York City

Current Law

The Job Creation and Worker Assistance Act of 2002 (the Act) provided tax incentives for the area of New York City damaged or affected by the terrorist attack on September 11, 2001. The Act created the "New York Liberty Zone," defined as the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. New York Liberty Zone tax incentives include: (1) an expansion of the work opportunity tax credit (WOTC) for New York Liberty Zone business employees; (2) a special depreciation allowance for qualified New York Liberty Zone property; (3) a five-year recovery period for depreciation of qualified New York Liberty Zone leasehold improvement property; (4) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property; (5) $9 billion of additional tax-exempt, advance refunding bonds; (6) increased section 179 expensing; and (7) an extension of the replacement period for nonrecognition of gain for certain involuntary conversions.[11]

The expanded WOTC credit provided a 40 percent subsidy on the first $6,000 of annual wages paid to New York Liberty Zone business employees for work performed during 2002 or 2003.

The special depreciation allowance for qualified New York Liberty Zone property equals 30 percent of the adjusted basis of the property for the taxable year in which the property is placed in service. Qualified property must be purchased by the taxpayer after September 10, 2001, and placed in service before January 1, 2007, or for nonresidential real property and residential rental property, January 1, 2010.

The five-year recovery period for qualified leasehold improvement property applies, in general, to buildings located in the New York Liberty Zone if the improvement is placed in service after September 10, 2001, and before January 1, 2007, and no written binding contract for the improvement was in effect before September 11, 2001.

The $8 billion of tax-exempt private activity bond financing is authorized to be issued by the State of New York or any political subdivision thereof after March 9, 2002, and before January 1, 2010.

The $9 billion of additional tax-exempt, advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain state or local bonds outstanding on September 11, 2001.

Businesses are allowed to expense the cost of certain qualified New York Liberty Zone property, up to an additional $35,000 above the amounts generally available under section 179.[12] In

[11] The Working Families Tax Relief Act of 2004 amended certain of the New York Liberty Zone provisions relating to tax-exempt bonds.

[12] Section 179 provides that, in place of depreciation, certain taxpayers, typically small businesses, may elect to deduct up to $100,000 of the cost of section 179 property placed in service each year. In general, section 179

addition, only 50 percent of the cost of such qualified New York Liberty Zone property counts toward the limitation under which section 179 deductions are reduced to the extent the cost of section 179 property exceeds a specified amount.

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the replacement period) property similar or related in service or use. In general, the replacement period begins with the date of the disposition of the converted property and ends two years (three years if the converted property is real property held for the productive use in a trade or business or for investment) after the close of the first taxable year in which any part of the gain upon conversion is realized. The Act extended the replacement period to five years for property in the New York Liberty Zone that was involuntarily converted as a result of the terrorist attacks on September 11, 2001, if substantially all of the use of the replacement property is in New York City.

Reasons for Change

Some of the tax benefits that were provided to New York following the attacks of September 11, 2001, likely will not be usable in the form in which they were originally provided. State and local officials in New York have concluded that improvements to transportation infrastructure and connectivity in the Liberty Zone would have a greater impact on recovery and continued development than would some of the existing tax incentive provisions.

Proposal

Provide tax incentives for transportation infrastructure

The Administration proposes to sunset certain existing New York Liberty Zone tax benefits and to provide in their place tax credits to New York State and New York City for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. New York State and New York City each would be eligible for a tax credit for expenditures 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, inclusive, subject to an annual limit of $200 million (for a total of $2 billion in tax credits), and would be divided evenly between the state and the city. Any unused credits below the annual limit would be added to the $200 million annual limit for the following year, including years after 2016. Similarly, expenditures that exceed the annual limit would be carried forward and subtracted from the annual limit in the following year. The credit would be allowed against any payments (other than payments of excise taxes and social security and Medicare payroll taxes) made by the city and state under any provision of the Internal Revenue Code, including income tax withholding. The Treasury Department would prescribe such rules as are necessary to ensure that the expenditures are made for the intended purposes. The amount of the credit received would be considered state and local funds for the purpose of any federal program.

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property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Repeal certain New York City Liberty Zone incentives

The following New York Liberty Zone incentives would be terminated as of the date of enactment: (1) the special depreciation allowance for qualified New York Liberty Zone property; (2) the five-year recovery period for depreciation of qualified New York Liberty Zone leasehold improvement property; (3) increased section 179 expensing for qualified New York Liberty Zone property; and (4) the extended replacement period for the nonrecognition of gain for certain involuntary conversions. Property placed in service after the date of enactment would be ineligible for the first three incentives listed above unless a binding written contract is in effect on the date of enactment and the property is placed in service before the original sunset dates set forth in the Act. The extended replacement period for involuntarily converted property would end on the earlier of (1) the date of enactment of the proposal or (2) the last day of the five-year period specified in the Act. Other related changes to the Internal Revenue Code would be made as appropriate.

Revenue Estimate

	Fiscal Years							
	2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
	($ in millions)							
1. Provide tax incentives for transportation infrastructure	--	-200	-200	-200	-200	-200	-1,000	-2,000
2. Repeal certain Liberty Zone incentives and other changes	--	200	200	200	200	200	1,000	2,000

SIMPLIFY THE TAX LAWS FOR FAMILIES

CLARIFY UNIFORM DEFINITION OF A CHILD

Current Law

A taxpayer may be eligible to claim a qualifying child for various tax benefits, including the dependent exemption, head of household filing status, the child tax credit, the child and dependent care tax credit, and the earned income tax credit (EITC). A qualifying child must meet the following three tests:

- Relationship – The child generally must be the taxpayer's son, daughter, grandchild, sibling, niece or nephew, or foster child.
- Residence – The child must live with the taxpayer in the same principal place of abode for over half the year.
- Age – The child must be under the age of 19, a full-time student if over age 18 and under age 24, or totally and permanently disabled. However, the child must be under age 13 for the child and dependent care tax credit and under age 17 for purposes of the child tax credit.

Additional requirements may apply to specific child-related tax benefits. For example, a taxpayer may claim a married child for the child tax credit, assuming the child meets the criteria listed above. However, for purposes of the dependent exemption and EITC, an individual generally cannot be a qualifying child if he or she is married and filing a joint return (unless that return is filed only as a claim for a refund).

A taxpayer cannot claim a qualifying child if the taxpayer is a qualifying child of another taxpayer. Further, a taxpayer, who is a dependent of another taxpayer, cannot claim a qualifying child for purposes of the personal exemption, head of household filing status, or the child and dependent care tax credit.

Under some circumstances (e.g., a three-generation household), two or more taxpayers may be eligible to claim the same child for tax benefits. Current law allows the eligible taxpayers to decide among themselves who will claim the child-related tax benefits. If more than one eligible taxpayer actually claims the same qualifying child, then the following tiebreaker tests determine which taxpayer is entitled to the child-related tax benefits.

- An eligible parent's claim supersedes all other claims.
- If the child's parents do not file a joint return and both claim the child on separate returns, then the tax benefits accrue to the parent with whom the child resides the longest. If both parents reside with the child for the same length of time, then the benefits accrue to the parent with the highest adjusted gross income (AGI).
- If the child's parents do not claim the child, then the tax benefits accrue to the claimant with the highest AGI.

Reasons for Change

The Working Families Tax Relief Act of 2004 (WFTRA) created a uniform definition of qualifying child, allowing, in many circumstances, a taxpayer to claim the same child for five different child-related tax benefits. WFTRA also simplified eligibility rules, making it easier for both taxpayers and the IRS to determine if an individual is a qualifying child. By eliminating a burdensome support test, WFTRA also reduced recording-keeping requirements.

However, WFTRA may have some unintended consequences. Under prior law, a taxpayer could not claim a sibling for certain child-related tax benefits unless the taxpayer could demonstrate that he or she cared for the sibling as if the sibling was the taxpayer’s own child. Congress repealed this factual test, responding to concern that it was difficult to administer. However, this change also effectively denied assistance to some low-income taxpayers who are the sole guardians of their siblings while giving higher-income families an opportunity to avoid income limitations on child tax benefits.

For example, a 20-year-old taxpayer works 30 hours a week at a minimum wage job while going to school full-time. Her parents are dead, and she is the legal guardian of her 15-year-old brother, with whom she resides for over half the year. Under prior law, she could claim her brother for the EITC because, in addition to meeting other requirements, she cared for him as if he were her own child. Under WFTRA, the brother is still considered the sister’s qualifying child. However, eliminating the “care for” test means that the 20-year-old is also considered to be the qualifying child of her 15-year-old brother: she meets the relationship, residency, and age tests. Because a qualifying child cannot claim another qualifying child, the older sister is not eligible for the EITC.[13]

In other cases, the elimination of the “care for” test makes it possible for some taxpayers to avoid income limitations on certain child-related tax benefits by allowing other family members, who have lower incomes, to claim the taxpayers’ sons and daughters as qualifying children. For example, a couple lives with their 26-year-old son and 16-year-old daughter. The son is not a qualifying child because of his age and his lack of a permanent and total disability. In addition, the son earns less than $30,000 a year, placing him in the EITC income range. If the parents have moderate income, they may find that the family could receive larger child tax benefits if their son claims his sister as a qualifying child and receives the EITC. For a very high-income couple, the gains to the family of allowing the son to claim the sister as a dependent may be even greater, because the couple’s income is too high to benefit from the dependent exemption and child tax credits, as well as the EITC.

Current law thus allows some families to obtain certain child tax benefits, even when the parents’ income is too high to qualify, while denying the EITC to some low-income working taxpayers who are the sole guardians of their siblings. Current law also creates complexity by encouraging families to engage in multiple computations in order to determine how to maximize tax benefits.

[13] The older sister, however, may be able to claim other child-related tax benefits. Under WFTRA, she is not a qualifying child (for purposes other than the EITC) if she provides over half of her own support.

WFTRA had other unintended consequences, which made some of the eligibility rules less uniform. For example, WFTRA allowed dependent filers to claim the child tax credit, even though they are generally ineligible for most other child-related tax benefits. WFTRA also allowed taxpayers to claim the child tax credit on behalf of a married child who files a joint return with his or her spouse, even though the taxpayer cannot generally claim other tax benefits for this child. These exceptions not only create confusion, but have led to the creation of a new tax form -- Form 8901 – solely to deal with these issues.

Proposal

The proposal clarifies the definition of a qualifying child and who is eligible to claim these children.

Definition of Qualifying Child. The proposal would stipulate that a taxpayer is not a qualifying child of another individual if the taxpayer is older than that individual. However, an individual could be a qualifying child of a younger sibling if that individual is permanently and totally disabled. In addition, an individual who is married and files a joint return (unless that return is filed only as a claim for a refund) would not be considered a qualifying child for the child-related tax benefits, including the child tax credit.

Eligibility of Taxpayer for Child-Related Tax Benefits. If a parent resides with his or her child for over half the year, only the parent would be eligible to claim the child as a qualifying child. However, the parent could waive the child-related tax benefits to another member of the household who has higher AGI and is otherwise eligible for the child tax benefits. In addition, dependent filers would not be eligible for child-related tax benefits.

The proposal would be effective for tax years beginning after December 31, 2006.

Revenue Estimate[14]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	17	236	246	282	282	1,063	2,619

[14] The estimate includes both receipt and outlay effects. The outlay effect is -$2,224 million for 2007-2016.

SIMPLIFY EITC ELIGIBILITY REQUIREMENT REGARDING FILING STATUS, PRESENCE OF CHILDREN, AND WORK AND IMMIGRANT STATUS

Current Law

Low and moderate-income workers may be eligible for the refundable earned income tax credit (EITC). Eligibility for the EITC is based on income, filing status, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on income. The rules regarding filing status, presence of children, and work and immigration status are particularly complicated and are described below.

Filing Status: An unmarried individual can claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally cannot claim the EITC unless they file jointly. However, there is an exception for estranged spouses who meet three requirements. First, an estranged spouse must live apart from his or her spouse for the last six months of the year. Second, the estranged spouse must maintain a household that constitutes the principal place of abode for a dependent child for over half the year. Third, the estranged spouse must pay over half the cost of maintaining the home in which he or she resides with the child during the year. If the estranged spouse meets these conditions, he or she may file a tax return as a head of household and claim the EITC.

Presence of Qualifying Children: A taxpayer who resides with a qualifying child may be eligible for an EITC of up to $2,747 ($4,536 for two or more children). A taxpayer who does not reside with a qualifying child may be eligible for a smaller credit of up to $412. A taxpayer may claim the EITC for workers without children only if the taxpayer does not reside with a qualifying child.

To be considered an EITC qualifying child, a child must meet residency, relationship, and age tests. Even if the child meets the three qualifying child tests, the taxpayer may not be able to claim the child or the EITC. For example, if more than one taxpayer lives with a qualifying child, only one of those taxpayers can claim the child for purposes of the EITC.[15] If a taxpayer lives with a qualifying child, but is not allowed to claim the child because the child is properly claimed by someone else, the taxpayer is not eligible for the EITC. Because the taxpayer resides with a qualifying child, he or she is ineligible for the EITC for workers without children.

A similar situation arises when a taxpayer resides with a qualifying child who does not have a valid social security number. The taxpayer is not eligible for the EITC for taxpayers with children because the child lacks a valid social security number. The taxpayer also is ineligible for the EITC for workers without children because he or she lives with a qualifying child.

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[15] If more than one taxpayer claims the same qualifying child for purposes of the EITC, then only the claimant with the highest adjusted gross income (AGI) is deemed eligible. However, a parent's claim supersedes the claims of other taxpayers, regardless of the outcome of the AGI tiebreaker test. If both parents file separate returns claiming the child, then the parent who resides with the child the longest is deemed entitled to the EITC. In the event that both parents reside with the child for the same amount of time, then the parent with the highest AGI is entitled to the EITC.

Work and Immigration Status: To claim the EITC, the taxpayer (including his or her spouse, if married) and qualifying child must have valid social security numbers. A social security number is considered invalid for EITC purposes if it was issued by the Social Security Administration *solely* to allow an individual to obtain federal benefits. Thus, an individual who is not authorized to work in the United States but who obtained a social security number in order to receive Medicaid or another federal benefit is not eligible for the EITC. However, an individual who is not authorized to work in the United States but who obtained a social security number for a reason other than to obtain federal benefits (e.g., a driver's license or for tax purposes prior to the creation of the ITIN) is eligible for the EITC.

The IRS may use math error authority to deny EITC claims when the taxpayer does not provide valid social security numbers.

Reasons for Change

According to the IRS, between \$8.5 and \$9.9 billion of EITC claims (27 percent to 31.7 percent of total claims) were erroneously paid with respect to tax year 1999 returns. Many of these errors related to taxpayers who failed to meet eligibility criteria concerning family and income status. Since 1999, a number of steps have been taken to improve compliance. Most notably, the Economic Growth and Tax Relief Reconciliation Act of 2001 contained several provisions that simplified the EITC eligibility rules and reduced noncompliance.[16] As a result of these efforts, the EITC error rate is estimated to fall to between 23 and 28 percent in 2006. Further simplification is needed to reduce these erroneous claims.

Some of the EITC errors may have been caused by taxpayer confusion over unusual family situations and the complicated tax rules that were created to address these situations. For example, an individual who has separated from his or her spouse is required to understand a complicated three-part test to determine his or her filing status under current law. Separated spouses may have to consult two IRS publications (Publication 596 on the EITC and Publication 501 on filing status) in order to determine if they are eligible for the EITC. They must compile and retain documentation showing that they provided over half the cost of maintaining the home in which they and their children reside. In tax year 1999, nearly \$1 billion of EITC overclaims were due solely to married taxpayers claiming single or head of household filing status when they should have filed as married-filing-separately. Many of these claims would not be erroneous if separated spouses were not required to document that they provide over half the cost of maintaining the household in which they reside with their children.

Other types of complicated family situations result in complicated tax rules. For example, if a child lives with her mother in her grandmother's home for over half the year, the child is a qualifying child of both her mother and grandmother. If the mother claims the child for the

[16] These provisions include a simplified tiebreaker test to resolve duplicate claims and to apply the same definitions of earned income and adjusted gross income used elsewhere in the tax code to the EITC. The recent adoption of a uniform definition of qualifying child will further reduce the complexity of the EITC eligibility criteria. In addition to these simplification efforts, the IRS has been implementing a new five-point initiative, which seeks to better detect erroneous claims before refunds are paid.

EITC, the grandmother is not eligible for the EITC for workers without children because she is still considered to have a qualifying child (her granddaughter). However, the grandmother may erroneously claim the childless EITC, not realizing that she is ineligible to claim the credit because she lives with her daughter and granddaughter. Taxpayers may be confused by the subtle difference between having a qualifying child one cannot claim for the EITC and having no qualifying child at all.

Efforts to target the EITC to specific populations also give rise to complexity. In some cases, targeting provisions may be more complicated than they were intended to be. A provision of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (the "1996 Act") was intended to deny the EITC to any person (including his or her spouse) who is not authorized to work in the United States. Individuals may obtain a social security number if they are citizens or permanent residents or other persons authorized to work in the United States. Individuals not authorized to work in the United States may also obtain a social security number in order to receive certain federal benefits. In addition, until recently, it was possible for some individuals to receive social security numbers for other reasons – e.g., to obtain a driver's license in some states or, before the adoption of ITINs, to file a tax return or claim certain tax benefits. As drafted, the 1996 Act denied the EITC to taxpayers who receive a social security number solely to receive federal benefits. The 1996 Act did not deny the EITC to individuals who are not authorized to work in the United States and who received social security numbers for reasons other than to obtain federal benefits. Thus, the statutory language in the 1996 Act did not have its intended effect. The disparate treatment of individuals with non-work-related social security numbers is confusing, inequitable, and difficult to administer. In tax year 2003, over $200 million of EITC overclaims were attributable to returns filed by taxpayers who did not provide valid social security numbers.

Proposal

Allow separated spouses to claim EITC. Married taxpayers who file separate returns would be allowed to claim the EITC if they live with a qualifying child for over half the year. They must also live apart from their spouse for the last six months of the tax year. However, they would not be required to provide over half the cost of maintaining the household in which they reside. The proposal would be effective for tax years beginning after December 31, 2006.

Simplify rules regarding presence of qualifying child. A taxpayer with a qualifying child who lives in an extended family would be eligible to claim the EITC for workers without children even if another member of the family claims the taxpayer's qualifying child. However, if unmarried parents reside together with their child, then one parent can claim the EITC for qualifying children, but neither can claim the EITC for workers without children.

Taxpayers would be eligible to receive the EITC for workers without children if their child does not have a valid social security number. As under current law, the taxpayer (and spouse, if married) must have a valid social security number. The proposal would be effective for tax years beginning after December 31, 2006.

Clarify when a social security number is valid for EITC purposes. To qualify for the EITC, a taxpayer (including his or her spouse, if married) must have a social security number that is valid for employment in the United States (that is, they are U.S. citizens, permanent residents, or have certain types of temporary visas that allow them to work in the United States).[17] The Treasury Department and the IRS will 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 new requirements. The proposal would be effective January 1, 2007.

Revenue Estimate[18]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	215	-147	-123	-122	-123	-300	-894

[17] Taxpayers who initially received a social security number for non-work reasons, but who subsequently became authorized to work in the United States (i.e., they became permanent residents or U.S. citizens), would be eligible to receive the EITC.

[18] The estimate includes both receipt and outlay effects. The outlay effect is $687 million for 2007-2016.

REDUCE COMPUTATIONAL COMPLEXITY OF REFUNDABLE CHILD TAX CREDIT

Current Law

An individual may claim a $1,000 tax credit for each qualifying child. A qualifying child must meet the following three tests:

- Relationship – The child generally must be the taxpayer's son, daughter, grandchild, sibling, niece or nephew, or foster child.
- Residence – The child must live with the taxpayer in the same principal place of abode for over half the year.
- Age – The child must be under the age of 17.

For purposes of the child tax credit, a qualifying child must be a citizen, national, or resident of the United States. The child tax credit is phased out for individuals with income over certain thresholds,[19] and is partially refundable.

Taxpayers may be eligible for a refundable amount (the additional child tax credit) equal to 15 percent of earned income in excess of $11,300.[20] Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EITC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income.[21]

Families with three or more children may determine the additional child tax credit using an alternative formula. A taxpayer can claim an additional child tax credit equal to the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit, if that amount is greater than the additional child tax credit based on the taxpayer's earned income in excess of $11,300.

Reasons for Change

The additional child tax credit is difficult to compute and unduly complicated. To compute the credit amount, low and moderate-income taxpayers must attach a separate form to their tax return. Many taxpayers with three or more children must compute the additional child tax credit twice to determine which formula yields the larger credit.

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[19] Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.

[20] The earned income threshold amount is indexed for inflation.

[21] For example, some ministers add parsonage allowances to self-employment income when computing the EITC, but such allowances are excluded from taxable income for purposes of the additional child tax credit.

In addition, the eligibility criteria for the additional child tax credit differ from those used for the EITC. (Over 70 percent of taxpayers who are eligible for the additional child tax credit also can claim the EITC.) Although both credits are based on earned income and the number of children in the family, they use different definitions of earned income and qualifying children. For example, when computing the additional child tax credit, taxpayers may count earned income only to the extent that it is included in taxable income; however, when computing the EITC, other types of income that are not included in computing taxable income are counted. Another example is that the additional child tax credit may be claimed by taxpayers who reside with children outside the United States, while the child-based EITC may be claimed only by taxpayers who reside with children in the United States.

Proposal

Eliminate Multiple Computations. Taxpayers with three or more children would no longer have the option to compute the additional child tax credit using an alternative formula that compares social security taxes paid to the amount of the EITC received. The additional child tax credit would be based solely on the formula that uses earned income, regardless of the number of children in a taxpayer's family.

Conform the Definition of Earned Income. The definition of earned income for purposes of the additional child tax credit would be conformed to that currently used for the EITC. Thus, earned income for both credits would equal the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. The proposal would eliminate the requirement that earned income be included in taxable income in order to be included in computing the additional child tax credit.

Require Taxpayers to Reside in the United States. 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 United States for any period the member is stationed outside the United States while serving on extended active duty. Extended active duty would include a call or order to such duty for a period in excess of 90 days.

The proposal is effective for tax years beginning after December 31, 2006.

Revenue Estimate[22]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	332	342	347	357	1,378	3,263

[22] Affects only outlays. The outlay effect is -$3,263 million for 2007-2016.

STRENGTHEN THE EMPLOYER BASED PENSION SYSTEM

ENSURE FAIR TREATMENT OF OLDER WORKERS IN CASH BALANCE CONVERSIONS AND PROTECT DEFINED BENEFIT PLANS

Current Law

Qualified retirement plans consist of defined benefit plans, which allocate investment risk to the plan sponsor, and defined contribution plans, which allocate investment risk to plan participants. In recent years, many plan sponsors have adopted cash balance and other "hybrid" plans that combine features of defined benefit and defined contribution plans. A cash balance plan is a defined benefit plan that provides for annual "pay credits" to a participant's "hypothetical account" and "interest credits" on the balance in the hypothetical account. As with traditional defined benefit plans, the sponsor of a cash balance plan bears investment risk (as well as some mortality risk), and benefits are guaranteed by the Pension Benefit Guaranty Corporation. Otherwise, the cash balance plan functions like a defined contribution plan from the perspective of a participant.

Questions have been raised regarding whether and how cash balance plans satisfy the rules relating to age discrimination and the calculation of lump sum distributions.

Age Discrimination. Code section 411(b)(1)(H) provides that a defined benefit plan fails to satisfy the benefit-accrual rules if, under the plan, a participant's benefit accrual is ceased, or the rate of a participant's benefit accrual is reduced, because of the attainment of any age. Section 204(b)(1)(H) of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4(i)(1)(A) of the Age Discrimination in Employment Act (ADEA) set forth similar rules.

Age-discrimination questions have been raised regarding two aspects of cash balance plans. First, some have argued that pay credits for younger participants provide higher benefits than the same pay credits for older participants because the pay credits for younger participants accrue interest credits over longer periods. Although one federal district court has agreed with this analysis, others have rejected it. *Compare Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (cash balance plan found age-discriminatory) *with Campbell v. BankBoston, N.A.*, 206 F. Supp. 2d 70 (D. Mass. 2002) (cash balance plan found not age-discriminatory), *aff'd*, 327 F.3d 1 (1st Cir. 2003), *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000) (same), *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004) (same) and *Register v. PNC Financial Services Group. Inc.,* No. 04-CV-6097, 2005 WL 3120268 (E.D. Pa., Nov. 21, 2005) (same).

Second, some have argued that "conversions" of traditional defined benefit plans to cash balance plans disadvantage older participants. A conversion occurs when a plan sponsor amends a traditional plan to make it a cash balance plan. A conversion can result in lower future accrual rates for some or all participants. If this occurs, ERISA section 204(h) and Code section 4980F require that participants receive advance notice. The conversion can also result in "wear-away" – a period following the conversion during which a participant's prior accrued benefits under the traditional plan exceed the benefits payable under the cash balance plan. Thus, during wear-away, the benefits under the cash balance formula of some or all participants must "catch up" with benefits accrued under the traditional plan. Wear-away may occur for the normal retirement benefit, the early retirement benefit, or both. However, under Code section 411(d)(6) and ERISA section 204(g), the conversion may not reduce the accrued normal or early retirement benefit of any participant.

Some have argued that the adverse effects of cash balance conversions fall more heavily on older participants than on younger participants because traditional plans usually provide more valuable accruals to older and longer-service participants. Many plan sponsors have adopted strategies to mitigate these effects, including protection of participant expectations through "choice" and "grandfathering" as well as avoidance of wear-away. However, these strategies have been voluntary, as current law generally gives the plan sponsor broad authority to amend a plan for any reason at any time. *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 443 (1999).

In December of 2002, Treasury and the IRS proposed regulations to address these and other age-discrimination issues. 67 *Fed. Reg.* 76123 (Dec. 11, 2002). The proposed regulations provide that a cash balance formula is not discriminatory as long as pay credits for older participants are equal to or greater than pay credits for younger participants. The proposed regulations also provide that cash balance conversions are not discriminatory as long as the conversions satisfy one of three permissible methods specified in the regulations. The proposed regulations do not prohibit reductions in future accrual rates or benefit wear-away because, under the conditions specified in the proposed regulations, those effects are not inherently age-discriminatory. To ensure time for Congress to consider legislative changes needed for cash balance plans, the Treasury Department has announced the withdrawal of these proposed regulations.

Calculation of Lump Sum Distributions. Three federal appellate courts have addressed the calculation of lump sum distributions under cash balance plans. *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), *cert. dismissed*, 531 U.S. 1061 (2001); *Lyons v. Georgia-Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000), *cert. denied*, 532 U.S. 967 (2001). All three courts held that a participant's hypothetical account balance must be projected to normal retirement age using the plan's interest crediting rate, converted to an annuity, and then discounted to a lump sum using the section 417(e) interest rate. If the plan's interest crediting rate is the section 417(e) rate, the present value of the normal retirement age annuity will be the same as the hypothetical account balance. However, if the plan's interest crediting rate is higher than the section 417(e) rate, the present value of the normal retirement age annuity – and the amount of any lump sum distribution – will be greater than the hypothetical account balance. This result is sometimes referred to as "whipsaw."

These federal court decisions have followed an analysis set out in IRS Notice 96-8. Many plan sponsors have responded to whipsaw by limiting the interest crediting rate to the section 417(e) rate (or a deemed equivalent). This response effectively makes the section 417(e) rate a ceiling on plan interest credits.

Reasons for Change

Although cash balance plans and cash balance conversions are not inherently age-discriminatory, current law does not provide adequate protection for older workers in every conversion. For example, the statutory age-discrimination rules do not prevent a plan sponsor from changing future benefit accruals. Also, current law does not prevent a plan sponsor from imposing wear-away of normal or early retirement benefits. (Current law actually restricts certain transition practices, such as preserving the value of early retirement subsidies through additions to participant account balances.) Many plan sponsors have voluntarily tried to mitigate any adverse effects that cash balance conversions may have on older and longer-service participants.[23] However, ensuring the fair treatment of older and longer-service participants in conversions requires strengthening current law to guarantee reasonable transition protections and to prohibit benefit wear-away.

Inconsistent federal court decisions make it necessary to clarify that cash balance plans are not inherently discriminatory as long as older participants are treated at least as well as younger participants. Removing uncertainty about the basic legality of cash balance plans is critical to preserving the vitality of the defined benefit system, which provides retirement income security for millions of American workers and their families.

As applied by the courts, the whipsaw effect under Notice 96-8 has harmed participants by leading plan sponsors to limit interest credits to the section 417(e) rate. This results in lower retirement accumulations for participants. The whipsaw effect should be eliminated so that plan sponsors can give participants higher interest credits.

Proposal

The proposal would accomplish three major objectives:

1. Ensure fairness for older workers in cash balance conversions.

2. Protect the defined benefit system by clarifying the status of cash balance plans.

3. Remove the effective ceiling on interest credits in cash balance plans.

Ensure fairness for older workers in cash balance conversions. The proposal would provide new protections for participants in cash balance conversions that would ensure fair transitions from traditional plans to cash balance plans. For each of the first five years after a conversion, the benefits earned by any current participant under the cash balance plan would have to be at least as valuable as the benefits the participant would have earned under the traditional plan if the conversion had not occurred. Additionally, there could be no wear-away of normal or early retirement benefits for any current participant at any time.

To prohibit violations of the new transition protections, there would be a 100 percent excise tax, payable by the plan sponsor, on any difference between the benefits required under the proposal and the benefits actually provided by the cash balance plan. In recognition of the fact that some

[23] The General Accounting Office reported that 84 percent of the employers that it surveyed provided full or partial transition relief in cash balance conversions. General Accounting Office, *Private Pensions: Implications of Conversions to Cash Balance Plans* at 33 (GAO/HEHS-00-185, Sept. 29, 2000); General Accounting Office, *Cash Balance Plans: Implications for Retirement Income* at 34-5 (GAO/HEHS-00-207, Sept. 29, 2000).

plan sponsors may be experiencing adverse business conditions, the amount of the excise tax could not exceed the greater of the plan's surplus assets at the time of the conversion or the plan sponsor's taxable income. Failure to implement the new transition protections would not result in disqualification of the plan.

The excise tax would not apply if participants were given a choice between the traditional formula and the cash balance formula or if the cash balance conversion grandfathered current participants under the traditional formula. This would preserve flexibility of plan sponsors to implement other provisions that protect older and longer-service participants.

Protect the defined benefit system by clarifying the status of cash balance plans. The proposal would clarify that a cash balance plan satisfies the age-discrimination rules if the plan provides pay credits for older participants that are not less than the pay credits for younger participants, in the same manner as any defined contribution plan. The proposal would also clarify that certain transition strategies used in conversions (such as preserving the value of early retirement subsidies) do not violate the age-discrimination or other qualification rules. The proposal would provide similar rules for other types of hybrid plans and for conversions from traditional plans to other types of hybrid plans.

Remove the effective ceiling on interest credits in cash balance plans. The proposal would eliminate whipsaw, providing that a cash balance plan may distribute a participant's account balance as a lump sum distribution as long as the plan does not credit interest in excess of a market rate of return. The Secretary would be authorized to provide safe harbors for what constitutes a market rate of return and to prescribe appropriate conditions regarding the calculation of plan distributions. This would permit plan sponsors to give higher interest credits to participants, resulting in larger retirement accumulations.

Conforming amendments and effective date. There would be conforming amendments under ERISA and the ADEA for statutory changes to the existing age-discrimination and distribution rules (but not for the new excise tax).

All changes under the proposal would be effective prospectively. The legislative history would state that there would be no inference as to the status of cash balance plans or cash balance conversions under current law.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
3	53	62	77	89	100	381	1,039

STRENGTHEN FUNDING FOR SINGLE-EMPLOYER PENSION PLANS

Current Law

Defined benefit pension plans are subject to minimum funding requirements imposed under both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA). In the case of a qualified plan, the Internal Revenue Code excludes contributions to defined benefit pension plans from the gross income of participants and allows the plan sponsor a deduction for the contributions, subject to certain limits on the maximum deductible amount. The calculation of the minimum funding requirements and the limits on deductible contributions are based on the plan's funding method, supplemented by calculations based on a comparison between the plan's assets and a more standardized measure of the plan's liability, known as current liability. These rules for defined benefit pension plans do not apply to governmental plans, church plans that have not made an election to be covered by ERISA and certain fully insured plans.

Calculations based on the plan's funding method

Selection and use of plan's funding method. A plan's funding method (selected from a number of acceptable actuarial cost methods) is used to determine the normal cost and, in some funding methods, an accrued liability. The normal cost is defined as the portion of the plan's liability that is attributable to the current year's service, as determined under the actuarial cost method. Depending on the actuarial cost method, the normal cost can be based on the benefits that accrue during the year (adjusted upwards for expected future pay increases in the case of a plan that provides for benefits based on final average pay) or can be a specified portion of the present value of the total benefits expected to be paid under the plan. The accrued liability is based on the portion of the present value of the total benefits that is associated with the past under the actuarial cost method. For example, the actuarial cost method that determines the normal cost as the present value of the benefits that accrue during the year determines the accrued liability as the present value of the benefits that accrued in prior years. However, some actuarial cost methods (such as the aggregate cost method) do not determine an accrued liability.

Actuarial value of plan assets. A plan's funding method also includes a method of determining the actuarial value of plan assets. The actuarial value of plan assets may differ from the fair market value of plan assets (e.g., it may be determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years), but must be between 80 and 120 percent of the fair market value of plan assets.

Actuarial assumptions. The actuarial assumptions that are used to determine liabilities under the plan's funding method are based on the actuary's best estimate of anticipated experience in the plan. For example, the interest rate must be the actuary's best estimate of the future earnings on plan assets. The actuarial valuation generally must be prepared by disregarding the possibility of future changes in the plan's benefit formula, the maximum benefit levels under section 415 or the section 401(a)(17) limit on the maximum compensation that can be taken into account under a qualified plan. However, if the plan is a single-employer collectively bargained plan, benefit increases must be taken into account if they are scheduled to take effect during the term of the current collective bargaining agreement.

Actuarial valuations. Each year, an actuarial valuation is prepared as of the valuation date for the year. The valuation entails the determination of the normal cost for the year, the determination of the accrued liability (in the case of a funding method that calculates an accrued liability) and a comparison of assets with liabilities as of the valuation date. The valuation date for a plan year is generally a date within the plan year or within the month preceding the beginning of the plan year. However, the valuation for a plan year may be made as of an earlier date within the prior plan year, provided that the value of the plan assets exceeded the current liability described below as of that earlier date and that adjustments are made for significant differences in participants.

Calculation of minimum funding requirement. As part of the valuation, the accrued liability is compared with the actuarial value of plan assets. If the actuarial value of plan assets is less than the accrued liability, the shortfall must be amortized in level payments over a number of years. The amortization period that applies depends on the source of the unfunded accrued liability. For example, to the extent the unfunded accrued liability is attributable to an actuarial loss, the amortization period is 5 years; but if it is attributable to a plan amendment adopted after 1976, the amortization period is 30 years. The minimum contribution for the year based on the plan's funding method (and subject to override as described below) is generally equal to the sum of the normal cost and the amortization payments for the year, adjusted by the funding standard account credit balance, as discussed below. If there have been actuarial gains or there have been changes in plan provisions or actuarial methods or assumptions that reduce the unfunded accrued liability, the amount of those gains or the reduction in unfunded accrued liability as a result of those changes is amortized over the same amortization periods that apply to the corresponding sources of unfunded accrued liability and each year's amortization credits are applied to offset the amortization charges with respect to actuarial losses or other increases in unfunded accrued liability.

Amortization extensions. A plan sponsor may apply for an extension of the amortization periods for a period of up to 10 years. The Internal Revenue Service may approve the extension only if it determines that the extension would carry out the purposes of ERISA and provide adequate protection for participants under the plan and that failure to permit the extension would be adverse to the interests of plan participants and would result in either a substantial risk that the plan would terminate or in a substantial curtailment of pension benefits or compensation levels. If an extension of the amortization periods is approved, a special interest rate is used to determine the amortization schedules.

Funding standard account. Compliance with the minimum funding requirements is monitored using a "funding standard account" that is credited with each year's contributions and charged with each year's minimum funding requirements. If a sponsor contributes more than the minimum required contribution for a plan year, the excess is maintained as a credit balance in the funding standard account. The excess contribution, together with interest at the valuation interest rate, may be applied as an offset to the next year's minimum funding requirements. If the credit balance is not used to offset the next year's requirements, the credit balance is carried forward, with interest at the valuation interest rate, to subsequent years.

Maximum deductible contribution and full funding limit under the plan's funding method

The maximum deductible contribution determined under the plan's funding method (subject to override as described below) is generally equal to the normal cost plus a 10-year amortization of any unfunded accrued liability. If an employer that sponsors a plan with an unfunded accrued liability contributes additional amounts in order to amortize the unfunded accrued liability more quickly (i.e., over a shorter period) than the schedule of amortization payments used to determine the minimum required contribution, the additional contributions are reflected in a credit balance in the funding standard account, as described above.

Full funding limit. To the extent the plan's assets (valued at the lesser of fair market value and actuarial value) exceed the plan's accrued liability (or the accrued liability under the entry age normal cost method if the plan's funding method does not determine an accrued liability), then the plan's deductible contribution determined under the plan's funding method (subject to the override described below) is equal to the normal cost minus that excess. In such a case, where the plan is at its "full funding limit," the required minimum contributions are also reduced. Thus, if the plan's assets (valued at the lesser of fair market value and actuarial value) exceed the plan's accrued liability by more than the normal cost for the year, unless one of the overrides described below applies, no deductible contribution is permitted and there is no minimum required contribution for the year. This is the case even if the plan is not adequately funded under a more accurate measure of liability.

Current liability and deficit reduction contributions

Current liability. The minimum required contribution and maximum deductible contribution calculated under the plan's funding method are subject to an override that is based on the plan's current liability. Current liability is calculated as the present value of the plan's benefits that have accrued as of the valuation date (other than benefits that will arise as a result of a future unpredictable contingent event, such as a plant shutdown), determined using certain standardized actuarial assumptions. For plan years beginning in 2004 or 2005, the interest rate used to determine current liability must be within the corridor of 90-100 percent of the weighted average of the rate of interest on long-term corporate bonds (as set forth in guidance issued by the IRS), where the average is determined for the 48 months preceding the first day of the plan year. For plan years beginning in 2006 and thereafter, current liability must be determined using an interest rate within the corridor of 90-105 percent of the weighted average of the rate of interest on 30-year Treasury bonds, with the same 48-month averaging period and weightings. The statute specifies that a standardized mortality table must be used in determining current liability, and IRS guidance provides that current liability is generally determined without recognizing the value of lump sum options under a plan.

Deficit reduction contribution requirement. The minimum funding requirements are supplemented by a requirement to make deficit reduction contributions in the case of a single employer plan sponsored by an employer that has more than 100 employees participating in defined benefit plans maintained by that employer. The deficit reduction contribution applies only when the actuarial value of the plan's assets is less than 90 percent of current liability. In addition, the deficit reduction contribution rules do not apply if the actuarial value of the plan's assets is between 80 and 90 percent of current liability, provided that the plan's assets were at least 90 percent of current liability in 2 consecutive years out of the last 3 years.

Deficit reduction contribution amount. If the plan is subject to the deficit reduction contribution rules, the minimum required contribution for the year is the greater of the minimum determined under the plan's funding method, as described above, and the sum of (1) the expected increase in current liability attributable to benefits accruing during the year, (2) an 18-year amortization of the unfunded current liability as of the first plan year beginning in 1988, (3) a specified percentage of the unfunded current liability (other than the unfunded current liability attributable to pre-1988 service and the current liability attributable to benefits arising as a result of the occurrence of an unpredictable contingent event, such as a plant shutdown), and (4) a specified contribution related to the current liability attributable to benefits arising from an unpredictable contingent event that has occurred. The specified percentage depends on the funded status of the plan (varying from 30 percent for a plan with a funded current percentage of 60, down to 18 percent for a plan with a funded current percentage of at least 90), generally corresponding to an amortization period of 4 to 7 years. Under the Pension Funding Equity Act of 2004, commercial airlines, steel manufacturers and certain other employers may elect to use special rules to reduce significantly the deficit reduction contribution for plan years beginning between December 28, 2003 and December 27, 2005.

Maximum deductible overrides. An employer may deduct amounts contributed to the plan that are not in excess of the amount necessary to bring the plan's assets up to the current liability, without regard to whether the plan assets exceed the accrued liability under the plan's funding method. For this purpose, current liability may, at the employer's election, be determined using an interest rate as low as 90 percent of the weighted average of the rate of interest on 30-year Treasury bonds. However, if the plan has fewer than 100 participants, the current liability is determined without regard to plan amendments increasing liabilities for highly compensated employees that are made in the last 2 years. If a single-employer plan that is insured by the Pension Benefit Guaranty Corporation (PBGC) terminates, the deductible contribution limit is increased to equal the amount required to make the plan sufficient for benefit liabilities.

Full funding limit override. Current liability also is used as an override to the otherwise applicable full funding limit for a plan. Under this rule, the full funding limit cannot be less than the excess of 90 percent of current liability (including the current liability normal cost) over the actuarial value of assets. Thus, a plan may not be treated as being at the full funding limit if the actuarial value of plan assets is less than 90 percent of the plan's current liability.

<u>Alternative minimum funding standard</u>.

As an alternative to applying the rules described above, a plan which uses the entry age normal cost method may satisfy an alternative minimum funding standard. Under the alternative minimum funding standard, the minimum required contribution for the year is generally based on the amount necessary to bring the plan's assets up to the present value of the accrued benefits, determined using actuarial assumptions that apply when a plan terminates. The alternative minimum funding standard has been rarely used.

Minimum funding waivers

If a plan sponsor of a single-employer plan is unable to satisfy the minimum funding requirements for a year without incurring temporary substantial business hardship, the plan sponsor may apply for a waiver of the funding requirements for that year. The Internal Revenue Service may approve the waiver application if it determines that the application of the minimum funding rules would be adverse to the interests of plan participants in the aggregate, but only if the plan has not obtained a waiver more than 3 times in a 15-year period. If the amount of the waiver is more than $1,000,000, the Internal Revenue Service must consult with the PBGC, and a waiver will generally be granted only if the employer provides adequate security. Once the minimum funding requirement for a year has been waived, the missed contributions must be amortized over a 5-year period, using a statutorily specified interest rate.

Failure to contribute minimum required funding

If a plan sponsor is a member of a controlled group of trades or businesses (generally based on 80 percent ownership) or an affiliated service group, all members of the group are joint and severally liable for satisfying the minimum funding requirements. A 10 percent excise tax applies if the plan sponsor fails to contribute the minimum required funding for a plan year (i.e., the plan has an accumulated funding deficiency). In addition, if the accumulated funding deficiency exceeds $1 million, a lien arises in favor of the PBGC. If the funding deficiency is not corrected before the Internal Revenue Service issues a notice of deficiency, the excise tax increases to 100 percent.

Timing rules for contributions

Minimum required contributions. If contributions are made on a date other than the date used in the actuarial valuation, the amount of the minimum contribution is adjusted with interest at the valuation interest rate, but not beyond the end of the plan year. If a single-employer plan had assets that were less than the current liability for the prior plan year, the minimum funding requirement for the current year must be substantially satisfied through quarterly contributions during the year. In addition, an employer sponsoring such a plan must make sufficient contributions during a year to ensure that the plan maintains sufficient liquid assets to pay 3 years' worth of benefits. Failure to maintain this balance as of the end of a quarter is known as a "liquidity shortfall" and is treated as a failure to meet the quarterly contribution requirements. Regardless of whether the quarterly contribution requirements apply, the period for making minimum contributions for a plan year extends to 8 ½ months after the end of the plan year. A contribution for the plan year that is made during this 8 ½ month period is included in the plan assets (as a contribution receivable) for the following plan year's actuarial valuation.

Failure to meet quarterly contributions. The sanction for failing to make the quarterly contributions is a requirement to increase the contributions using a statutorily specified interest rate that was intended to be higher than the otherwise applicable rate. In addition, if the missed contributions total more than $1 million, a lien arises in favor of the PBGC. If a plan has a liquidity shortfall, the amount of the shortfall is treated as a failure to meet minimum funding requirements, giving rise to the excise tax described above.

Deduction rules. An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to the plan that do not exceed the maximum deductible contribution, provided that the contributions are made prior to the tax filing deadline for the tax year. Contributions for a tax year that exceed the greater of the maximum deductible contribution and the full funding limit are subject to an excise tax if the employer is a taxable entity (including a tax-exempt employer that has ever paid unrelated business income tax).

<u>Form 5500, Schedule B actuarial statement and summary annual report (SAR)</u>

Form 5500 and Schedule B actuarial statement. Pension plans generally are required to file an annual report and annual return under ERISA and the Internal Revenue Code. The Department of Labor, Internal Revenue Service and PBGC have consolidated these requirements into the Form 5500. Defined benefit pension plans subject to minimum funding standards generally are required to file an actuarial statement (Schedule B) each year with their Form 5500. The Schedule B must be certified by an enrolled actuary and must report information on the plan's assets, liabilities and compliance with funding requirements.

The Form 5500 is due 7 months after the end of the plan year (the end of July for a calendar year plan). However, a 2 ½ month extension is available (to October 15 for a calendar year plan). Copies of the plan's Form 5500, including the Schedule B actuarial statement and funding information, must be made available upon request to plan participants and beneficiaries receiving benefits under the plan. The Form 5500 also may be obtained by participants, beneficiaries, and the general public from a public document room at the Department of Labor.

Summary annual report (SAR). Under ERISA, pension plans are required to furnish a summary of the Form 5500 to participants and beneficiaries receiving benefits under the plan. Plans must use a format set forth in Labor regulations to disclose basic financial information about the plan reported on the Form 5500. The SAR also must include a statement that enough money was contributed to the plan to keep it funded in accordance with the minimum funding standards, or that not enough money was contributed to the plan to keep it funded in accordance with the minimum funding standards and the amount of the deficit. If the current value of the assets of a plan is less than 70 percent of the current liability under the plan, the SAR also must include the percentage of such current value of the plan's assets. The SAR must be furnished within 9 months after the end of the plan year (or, if an extension applies for the filing of the Form 5500, 2 months after the extended due date).

Participant notice of underfunding. Under section 4011 of ERISA, plan administrators of certain underfunded single-employer defined benefit plans covered by the PBGC benefit guarantee program are required to notify participants, beneficiaries, alternate payees under qualified domestic relations orders, and collective bargaining representatives, if any, of the plan's funding status and the limits of the PBGC's guarantee. The notice must be furnished no later than 2 months after the filing deadline for the Form 5500 for the previous plan year and may be distributed with the plan's SAR. Generally, plans that are less than 90 percent funded and required to pay a variable rate premium to the PBGC under its guarantee program are required to issue such notices. However, in recent years, most plans have been exempt from paying variable rate premiums as a result of being at the "full funding limit."

Grandfathered floor-offset plans

ERISA prohibits a defined benefit plan from acquiring employer securities or employer real property if immediately after such acquisition such assets would exceed 10 percent of the fair market value of the assets in the plan. Under a floor-offset arrangement, the defined benefit plan provides the floor, or minimum benefit. That benefit is then offset, or reduced, by the annuitized benefit the defined contribution plan could provide.

The Pension Protection Act of 1987 (PPA 1987) amended ERISA to take assets under a defined contribution plan that is part of a floor-offset arrangement into account for purposes of the 10 percent limit. Thus, the limit applies on an aggregated basis to affected floor-offset arrangements, aggregating the separate but associated defined benefit and defined contribution plans. However, the PPA 1987 amendment only applies to floor-offset arrangements established after December 17, 1987, so that defined contribution plans that are part of floor-offset arrangements established on or before December 17, 1987 (so-called "grandfathered floor-offset arrangements") are not subject to this limit.

Benefit limitations

Plan amendments increasing benefits in severely underfunded plans. If an employer with more than 100 participants in defined benefit plans amends the plan to increase benefits, the employer is required to post security before the plan amendment can take effect if, after the plan amendment, the actuarial value of the plan's assets would be less than 60 percent of current liability (determined without regard to the unamortized portion of pre-1988 unfunded current liability). The amount of the required security is the amount by which the assets are less than 60 percent of current liability after the amendment (or, if smaller, the aggregate increase in current liability attributable to all post-1988 benefit increase amendments), but only to the extent this amount exceeds $10 million.

Other limitations on benefit increases. In the case of a defined benefit plan sponsored by an employer in bankruptcy, an amendment improving the plan's benefits generally may not be made effective until the reorganization is complete. Similarly, if an employer has an outstanding minimum funding waiver for a defined benefit plan or has had the amortization period extended, the plan generally may not be amended to improve benefits.

Limitations on lump sums for plans experiencing liquidity shortfalls. Under section 206(e) of ERISA, a plan that has a liquidity shortfall may not make lump sum payments (or other similar benefit payments that deplete plan assets on an accelerated basis) during the period of the shortfall. The limitation on payments during the period of a liquidity shortfall extends to lump sum payments and any other payment that is larger than a single life annuity (plus any social security supplements) and to the purchase of an annuity from an insurer. Under the Internal Revenue Code, a plan will not be disqualified merely because benefit payments are not made in accordance with this limitation during the period of liquidity shortfall.

Executive funding for nonqualified deferred compensation. Companies can fund nonqualified deferred compensation arrangements for executives through a variety of mechanisms that secure benefits by segregating assets in a funding vehicle that is not fully available to creditors, such as rabbi trusts and insurance policies, without regard to the funded status of the company's pension plans for employees generally.

Reasons for Change

The pension funding rules should ensure that pension promises made by businesses to workers and retirees will be honored. The recent economic climate has exposed severe weaknesses in the pension funding rules. These weaknesses have resulted in serious plan underfunding, and terminations of underfunded plans have led to benefit losses for plan participants and record deficits for the PBGC. The fact that there have been successive and worsening pension funding crises over time demonstrates that fundamental reform is needed.

Increased claims for plan terminations of significantly underfunded pension plans have resulted in a significant deficit in the single-employer insurance fund of the PBGC. As of the end of the fiscal year ending September 30, 2005, the deficit in that fund is nearly $23 billion. The large PBGC deficit and high levels of plan underfunding are themselves a cause for concern. More importantly, however, they are symptomatic of serious structural problems in the private defined benefit system. It is important to shore up this structure and strengthen the financial health of defined benefit plans. If significantly underfunded pension plans continue to terminate, not only will workers lose benefits, but other companies (including those that are healthy and have funded their plans in a responsible manner) may have to pay significantly higher PBGC premiums or other steps will be needed in order to protect plan participants and maintain the solvency of the pension insurance program.

One reason for this problem is the byzantine and often ineffectual set of funding rules under current law. They are needlessly complex and fail to ensure that many pension plans become and remain adequately funded. Current rules give employers too much discretion in setting their funding targets and provide insufficient opportunity for plans to become well funded. Current rules also do not provide enough incentive to be well funded because there are few significant consequences that arise from a plan being poorly funded, especially for a plan sponsor in poor financial health.

Current measures of plan funding are not based on measures of assets and liabilities that are meaningful and accurate

Funding targets should not be manipulable. Because a plan's apparent funded status is a function of its chosen actuarial cost method, there is no uniformity in liability measures under current law. Furthermore, a plan actuary has substantial discretion in selecting an interest rate and the interest rates chosen commonly reflect the high rate of return that is anticipated from investing in equities. As a result, companies can report that their pension plans are fully funded, when in fact they are substantially underfunded using a more meaningful and accurate measure of liability.

Liabilities should be measured accurately using current interest rates. Current law attempts to address the manipulability of the funding target by overlaying the requirement to make a deficit reduction contribution, which is based on a more standardized measurement of current liability. The deficit reduction contribution override to the minimum funding requirements has not been wholly effective, as a number of employers have adopted a funding policy that just keeps the plan's assets at 90 percent of current liability in order to avoid application of the deficit reduction contribution. Moreover, current liability has a number of structural flaws that result in that value having no obvious relationship to the amount of assets needed to pay all of the plan's benefit liabilities if the plan were to terminate.

One such flaw is that the interest rate used in determining current liability can be selected from an interest rate corridor that is based on an average of interest rates over the prior 48 months. As a result, during periods of rapidly changing interest rates, the current liability interest rate can be significantly out-of-date. Furthermore, the extent to which the current liability interest rate is higher or lower than current interest rates is unpredictable. For example, in February 2005, the weighted average of the long-term corporate bond rates used to determine current liability was 6.07 percent, while the actual rate for that month was 5.36 percent -- such an interest rate difference (.71 percent) can by itself materially understate plan liabilities.

Even when the current liability interest rate reflected current market conditions (for example, in November 2005, when the difference between the 4-year weighted average and the current rate was only 1 basis point , it would produce an inaccurate measure of the plan's true liability because it is based on a long-term interest rate and fails to take into account the actual timing of when benefit payments will be due under the plan, which might be -- and often is -- considerably sooner). As anyone who has ever compared the interest rates on a 15-year and a 30-year mortgage knows, market interest rates are sensitive to the timing of the relevant cash flows.

Assets also should be measured accurately. The use of a smoothed actuarial value of assets distorts the funded status of the plan. Using fair market value for purposes of the funding rules would give a clearer picture of a plan's funded status.

The risk of termination must be recognized for plan sponsors in poor financial health. In addition to other flaws, the funding targets under current law fail to reflect the additional costs that an insurer would charge in providing annuities for a terminating plan. Pension plans sponsored by firms in poor financial health pose substantial risk of termination and losses to plan participants and the pension insurance fund. Under current rules, such plans are not required to fund to a target that adequately reflects the final costs of terminating the plan. While it is not necessary for all plans to fund to such a high standard, the pension funding target for a plan should not be based on the assumption that the plan will survive indefinitely, particularly if there is a substantial risk that the plan will terminate. Accordingly, the pension funding rules should not be based on the fundamental assumption that plan assets will always be able to earn an equity premium or that plans will be able to earn a long-term interest rate to meet short-term obligations. In addition, in the case of a plan with a substantial risk of terminating, the pension funding target should reflect the additional cost of terminating the plan and that plan participants are increasingly likely to retire early and to take their benefits in lump sum form.

Because of these flaws in measurements of liabilities and the permitted smoothing of assets, funding ratios based on current law measures of assets and liabilities often provide an inaccurate picture of a pension plan's true financial status. This is especially true when the smoothed current liability is compared with a smoothed actuarial value of assets which can be substantially above market value. Inaccurate asset and liability measures can contribute to unpleasant surprises about a plan's funded status for participants if their pension plan terminates. Recent well-known plan terminations include a case in which the plan appeared to be 84 percent funded on a current liability basis in the year before the plan termination, but when the plan actually terminated it turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. In another case, the plan appeared to be 94 percent funded on a current liability basis in the year before the plan terminated, but when it terminated, the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. Had these plans been required to use a liability measure that reflected current market interest rates, the timing and form of benefit payments, and the cost associated with an actual plan termination, and had that liability been compared to the market value of assets, the stated funded status of the plan prior to termination would not have been so misleading.

<u>Underfunded plans should make up their shortfalls over a reasonable period and without funding holidays until the shortfall is eliminated</u>

Amortization periods are too long. The current law 30-year amortization period for plan amendments is too long, as there is too much risk that the plan will be terminated before the 30 years is completed. Furthermore, collectively bargained plans often have a series of benefit increases every few years. As a result, these plans are perennially underfunded. While the deficit reduction contribution override was designed to address this problem (as well as the discretion in setting funding targets under the plan's funding method), its effectiveness has been limited by the ability of a plan sponsor to avoid the application of the deficit reduction contribution by keeping a plan funded just above 90 percent of current liability, as noted above.

Funding standard account credit balances should be eliminated. One flaw in the current funding rules worth highlighting is the treatment of funding standard account credit balances. The credit balance rules allow an employer to apply their additional contributions from an earlier year -- with assumed interest -- as an offset to the minimum funding requirement for the current year without restriction. This allows a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market -- and, more importantly, regardless of the current funded status of the plan. In the two dramatic plan termination cases cited above, the credit balance in the funding standard accounts served to fully offset otherwise required contributions. As a result, no contributions were made to either plan during the three or four years leading up to plan termination. The law needs to provide an incentive to adequately fund plans at an appropriate level, without the volatility inherent in a credit balance system.

<u>The rules should provide employers with the opportunity for additional funding</u>

Additional tax-deductible contributions should be permitted. The rules should provide greater flexibility for employers to make additional contributions in good economic times. The current funding rules can conceivably place a pension plan sponsor in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. This problem is caused by the interaction of the minimum funding requirements, which are designed to ensure the pension plan's financial integrity, the rules governing maximum deductible contributions, which are designed to limit excessive tax deductions, and the excise tax on nondeductible contributions. Prohibiting tax-deductible contributions whenever the plan’s assets exceed the greater of the plan’s accrued liability and the plan’s current liability restricts the ability to build up a cushion that employers can use to protect themselves from the risk that contributions will have to be severely increased in poor economic times. The law should be revised to allow higher tax-deductible contributions during good economic times that would minimize precipitous funding increases during tough economic times, and thereby allow a plan sponsor to guard against future periods of low sponsor earnings and/or periods of poor plan asset returns.

Accurate information about a plan’s funding status is needed earlier

As indicated above, asset and liability measures under current law are often not accurate and meaningful measures of the plan’s funding status. As a result, participants who have lost benefits when their badly underfunded plan was terminated have often had no advance warning, or were led to believe that the level of underfunding was not significant. Information on a plan’s funding target and a comparison of that liability to the market value of assets would provide more accurate disclosure of a plan’s funded status. Providing the participants and beneficiaries with information on the funded status of a plan on a more timely basis would also make this information more useful to them.

The current deadline for filing Form 5500 means that the regulatory agencies are not notified of the plan’s funded status for almost 2 years after the actual valuation date. If the market value of a plan’s assets is less than its funding target, the relevant regulatory agencies need to monitor whether the plan is complying with the funding requirements on a more current basis.

Eliminate grandfather for pre-1988 floor-offset plans

The PPA 1987 grandfather for pre-1988 floor-offset plans means that participants in such an arrangement are at significant risk. If a company with a grandfathered floor-offset arrangement goes out of business, the employer stock held in the related defined contribution plan typically becomes worthless, with the result that the defined benefit plan is left with a large unfunded liability. This problem has been highlighted by the recent events surrounding the financial difficulties of the Enron Corporation, which had maintained a grandfathered floor-offset plan.

Stronger consequences should apply for persistently underfunded plans

Restraining liability increases in significantly underfunded plans. Companies should be held accountable to make good on the pension promises they have made to their workers and retirees. The consequence of not honoring these commitments is that the retirement security of millions of current and future retirees is put at risk. Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in some situations even make benefit improvements, while pushing the cost of paying for those benefits off into the future. For this reason, companies have an incentive to provide generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. If a company's plan is poorly funded, the company should be precluded from adopting further benefit increases unless it fully funds them, especially if it is in a weak financial position.

Lump sums should be restricted in severely underfunded plans. If a plan is severely underfunded, retiring employees should not be able to elect lump sums and similar accelerated benefits because the payment of those benefits allows those participants to receive the full value of their benefits while depleting the plan assets for the remaining participants. A similar concern applies when a severely underfunded plan purchases annuities.

Additional risk from plan sponsors in poor financial health. Recent history has demonstrated that pension funding risk is greatest for employers in poor financial health. Furthermore, financial discipline from plan sponsors cannot be expected if there are no consequences associated with the lack of such discipline. Thus, if an employer is recognizably in financial difficulty and its pension plan is significantly underfunded, even more serious measures are called for. Such a plan should be frozen until the funding improves.

<u>Other changes are needed</u>

PBGC premium changes. The current premium structure for the PBGC requires a redesign. Not only are the premiums too low to cover the PBGC's expected claims, much less to improve its financial status, but they do not take into account the different risks of termination for different plans. As a result, healthy plan sponsors are subsidizing plan sponsors that have not acted as responsibly. A properly designed insurance system has various mechanisms for encouraging responsible behavior that will lessen the likelihood of incurring a loss and discouraging risky behavior that heightens the prospects of claims. This problem requires changes in our Nation's pension insurance guarantee system, which are included in the budget being proposed by the Department of Labor and the PBGC.

Executive funding for nonqualified deferred compensation. Executives of companies in financial difficulty should not be able to benefit by having their nonqualified deferred compensation arrangements funded and made more secure, without addressing the risk to the retirement income of rank and file employees caused by severely underfunded pension plans. Rules also are needed that would preclude funding executive compensation arrangements at a time close to termination of an underfunded pension plan covering rank and file employees.

Plant shutdown benefits should not be permitted. A recurring problem in pension funding is that a plan may have special benefits that are only payable in the event that the location at which workers are employed ceases operations. Such events are inherently unpredictable, so that it is difficult to recognize the costs of these benefits in advance, and current law does not include the cost of benefits arising from future unpredictable contingent events in current liability. Yet these benefits can dramatically increase the level of underfunding in a plan and by themselves have been a considerable source of pension funding problems. Allowing -- and guaranteeing – plant shutdown benefits raises fairness issues since other participants and plan sponsors may bear the burden of paying for these unfunded benefits.

PBGC guarantee limitations in bankruptcy. While current law limits the benefit increases that can be adopted when a company goes into bankruptcy, the amount of the PBGC guarantee continues to increase. These guarantees should not continue to grow, especially if bankruptcy courts are permitting employers to pay less than the minimum required contribution while they are in bankruptcy. A proposal to freeze the PBGC guarantee during bankruptcy is included in the budget being proposed by the Department of Labor and the PBGC.

Perfection of lien in bankruptcy. When missed contributions exceed $1 million, a lien arises under current law. While the PBGC normally may perfect that lien, there is an automatic stay during a bankruptcy which prevents the PBGC from perfecting that lien. A proposal to allow perfecting of these liens during bankruptcy is included in the budget being proposed by the Department of Labor and the PBGC.

Multiemployer plans

While changes in the current law funding rules may also be needed for multiemployer pension plans, there are other factors involved that relate to the funded status of multiemployer plans. These factors are under study and, accordingly, the funding rules applicable to multiemployer plans are not being addressed at this time.

Proposal

Effective for plan years beginning on or after January 1, 2007, the multiple sets of funding rules applicable to single-employer defined benefit plans would be rationalized and replaced with a single set of rules that provide for: (1) funding targets that are based on meaningful, accurate measures of liabilities that reflect the financial health of the employer; (2) the use of market values of assets; (3) a 7-year amortization period for funding shortfalls; (4) the opportunity for an employer to make additional deductible contributions in good years, even when the plan's assets are above the funding target; and (5) meaningful consequences for employers and plans whose funded status does not improve. Governmental plans, non-electing church plans and fully insured plans would continue to be excluded from the minimum funding rules.

These funding rule changes, the addition of meaningful consequences for employers and plans whose funded status does not improve, and improved disclosure to plan participants, investors and regulators, are part of an overall package of reforms that will improve the health of defined benefit pensions and the PBGC guarantee system. As described in the section of the President's Budget relating to the PBGC, this overall package also includes a reform of the premium structure for the PBGC, a freeze on the PBGC guarantee during bankruptcy, and a change to the bankruptcy law.

For plans years beginning in 2006, the determination of the minimum funding requirement would be the as for plan years beginning in 2004 and 2005, including the continued use of the .corporate bond interest rate to determine current liability.

Funding targets that are based on measures of liabilities that are meaningful and accurate and that reflect the financial health of the employer

Funding targets that depend on the plan sponsor's financial health. The minimum required contribution to a single-employer defined benefit pension plan would be based on funding targets that vary depending on the financial health of the plan sponsor. For a plan sponsor that is healthy (i.e., the plan sponsor is not financially weak, as defined below), the funding target is the plan's ongoing liability. For a plan sponsor that is financially weak, the funding target generally is the plan's at-risk liability. However, if the plan sponsor has become financially weak within the past 5 years, there is a phase-in of the target liability, as described below.

Definition of financially weak. A plan sponsor is financially weak for a plan year if, as of the valuation date, any plan sponsor for the plan has senior unsecured debt that is rated as not being investment grade by each of the nationally recognized statistical rating organizations that has issued a credit rating for the debt (or, if no plan sponsor has senior unsecured debt that is rated, all of the nationally recognized statistical rating organizations that have made an issuer credit rating for any plan sponsor have rated the sponsor as less than investment grade). However, a plan sponsor would not be treated as financially weak if any significant member of the controlled group (whether or not a plan sponsor) has senior unsecured debt that is rated as being investment grade.

In addition, a plan sponsor is automatically treated as not being financially weak if it has neither senior unsecured debt that is rated nor an issuer credit rating and the employer does not maintain defined benefit plans covering at least 500 participants. In the case where no plan sponsor has either senior unsecured debt that is rated or an issuer credit rating and the employer maintains defined benefit plans covering at least 500 participants, the determination of whether the sponsor is financially weak would be made under regulations. It is expected that the regulations would generally determine whether the sponsor is financially weak based on financial measures, such as whether the long-term debt to equity ratio of the controlled group is 1.5 or more, with debt to include the unfunded pension liability (at-risk liability) and equity to be based on fair market value for a privately held company or market capitalization for a company whose stock is publicly traded.

Changes in financial health. If a sponsor's financial health worsens (i.e., the plan sponsor becomes financially weak) during a plan year (including having become financially weak before enactment), the change in the applicable funding target (and the associated normal cost) is phased in ratably over a 5-year period following the year the plan sponsor becomes financially weak (without regard to whether any of those years were prior to enactment). However, if a sponsor's financial health improves so that it becomes healthy during a plan year, the funding target changes to ongoing liability for the next plan year.

Ongoing liability. Ongoing liability is equal to the present value of all benefits that the plan is expected to pay in the future, based on benefits earned through the beginning of the plan year (including early retirement and similar benefits that the participant will grow into with future service to the extent of the benefits earned as of the beginning of the plan year). Present value is determined by discounting the future expected payments under the plan for the time value of money using the corporate bond yield curve described below, where the expected payments are determined using a mortality table prescribed by the Secretary of Treasury. Each other assumption, including the plan's turnover and retirement assumption, is required to be actuarially reasonable based on the plan's experience (or other relevant historical experience if the plan has no experience). The probability that future payments will be made in the form of a lump sum payment is among the factors that are required to be taken into account. Ongoing normal cost is the present value of all benefits that the plan is expected to pay that accrue during the plan year (including any increase in benefits earned in prior years attributable to compensation increases), calculated using the same assumptions as are used for determining ongoing liability.

At-risk liability. At-risk liability would be based on the same benefits and assumptions as ongoing liability, except that the valuation of those benefits would require the use of certain actuarial assumptions that would take into account the fact that a plan maintained by a financially weak plan sponsor has a greater likelihood to pay benefits on an accelerated basis or to terminate its plan. The modified actuarial assumptions are: acceleration in retirement rates using the earliest early retirement age; and benefits being distributed in a lump sum payment (or in whatever other form of distribution results in the largest liability for the plan). These assumptions are designed to reflect behavior that typically occurs prior to plan termination when the financial health of the employer deteriorates. In addition, at-risk liability includes a loading factor to reflect the additional administrative cost of purchasing a group annuity if the plan were to terminate: the loading factor is $700 per participant plus 4 percent of the at-risk liability before the loading factor. In no event would the at-risk liability for the plan be less than ongoing liability for the plan plus the loading factor (which could occur, for example, if the earliest retirement age assumption were to result in less valuable benefits). At-risk normal cost is the same as ongoing normal cost, except that at-risk normal cost is generally calculated using the assumptions that are used for determining at-risk liability (but does not include the $700 per participant loading factor).

Interest rates used for present value calculations to be based on a yield curve. The applicable funding target and normal cost would be determined using a series of interest rates drawn from a yield curve for high-quality zero-coupon corporate bonds. This corporate bond yield curve would be issued monthly by the Secretary of Treasury and would be based on the interest rates (averaged over 90 business days) for high quality corporate bonds (i.e., bonds rated AA) with varying maturities. Thus, the interest rates that are used in calculating ongoing liability and at-risk liability would vary, depending on how many years in the future a participant's benefit payment will be made. In the usual situation of an upwardly sloping yield curve, higher interest rates would be used to discount benefit payments expected to be made further in the future, with lower interest rates applying for benefit payments made in the near term.

Transition rules. For plan years beginning in 2007 and 2008, the funding target would be determined as the weighted average of the value of the applicable funding target liability and normal cost for the plan, determined using the methodology described above, and that same liability and normal cost determined using the transition interest rate. The transition interest rate is the interest rate that would have been used to determine current liability if the law applicable to current liability for 2005 were to continue to apply for 2006, 2007 and 2008. For 2007, the weighting factor would be 2/3 for the calculation using the transition interest rate and 1/3 for the calculation using the corporate bond yield curve; and for 2008, the weighting factors would be reversed.

Valuation dates. A plan's funding target (based on ongoing liability or at-risk liability, as applicable) and the market value of its assets for any plan year would be determined as of the valuation date for that year. A plan's valuation date may be any day of the plan year if the plan has 100 or fewer participants, and must be the first day of the plan year if the plan has more than 100 participants. If the valuation date is after the first day of the plan year, the funding target excludes the present value of benefits accrued between the first day of the year and the valuation date. For purposes of determining plan assets at the valuation date, any contribution that has been made for the current plan year is disregarded and any contribution to be made for the prior plan year that has not yet been paid is included in the plan assets as a contribution receivable. However, for plan years beginning in 2008 and later, only the present value of that contribution receivable is included in plan assets, with the present value to be determined using the average effective interest rate that applied in determining the prior year's funding target.

Minimum contributions for plans with market value of assets below funding target

If, as of the valuation date for a plan year, the market value of plan assets is less than the applicable funding target for the year, the minimum required contribution for the year would be equal to the sum of the applicable normal cost for the year and the required amortization payments for the shortfall, as described below. The alternate minimum funding standard account would be eliminated, but current law permitting waivers of minimum funding requirements would continue to apply.

*Amortization payments***.** Amortization payments would be required in amounts that amortize each amortization base over a 7-year period. The initial amortization base is established as of the valuation date for the first plan year beginning in 2007 and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in 7 payments, beginning with a payment as of the valuation date for that plan year and continuing on a level basis at each valuation date for the next 6 plan years, where the level amortization payments are determined based on the applicable interest rates under the corporate bond yield curve.

For each subsequent plan year, if, at a valuation date, the sum of the market value of assets and the present value of future amortization payments (with the present value determined using the corporation bond yield curve as of the current valuation date) is less than the funding target, an additional amortization base equal to that shortfall is established. That shortfall is similarly amortized in 7 equal payments. The current law rules regarding extension of amortization periods would no longer be available to reduce the minimum funding requirements for a single-employer plan.

This process (i.e., comparing the funding target to the sum of the market value of assets and the present value of future amortization payments for past amortization bases, and establishing a new amortization base if there is a shortfall) is repeated each year on the valuation date. If, at any valuation date, the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year (except to the extent amortization payments for a prior amortization base cease because that base has completed its 7-year amortization period). The amortization payments for each amortization base would continue unchanged for 7 years (or until the market value of the plan's assets on a valuation date equals or exceeds the funding target if earlier). If, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.

Timing rules. The quarterly contribution rules would apply to all plans that have assets less than the funding target as of the prior valuation date, and the deadline for the final contribution for the year would continue to be 8 ½ months after the end of the plan year. A contribution made after the valuation date for the year would be credited against the minimum required contribution for the year based on its present value as of the valuation date, discounted from the date actually contributed and determined using the average effective interest rate that applied in the determination of the funding target under the actuarial valuation.

Required funding and opportunity to increase funding in good years

If, as of the valuation date, the market value of plan assets exceeds the funding target by more than the applicable normal cost, there would be no required funding for the year. If the market value of plan assets exceeds the funding target, but by an amount that is less than the normal cost for the year, the required funding for the plan would be equal to the normal cost minus the excess of the plan assets over the funding target. However, any plan sponsor would be permitted to make additional deductible contributions up to the maximum deductible amount.

Maximum deductible amount. Funding would be permitted on a tax deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year, the applicable normal cost and a specified cushion. The cushion amount is defined as the sum of (1) 30 percent of the plan's funding target and (2) an increase to reflect how much larger the funding target and applicable normal cost would be if they were to take into account anticipated future salary increases, or future benefit increases (based on the average for the past 6 years) in the case of plans under which the benefits for service to date are not based on compensation. To determine how much larger the funding target and applicable normal cost would be if they were to take into account anticipated future salary or benefit increases, the salary or benefit increase is applied to increase benefits under the plan formula based on service as of the valuation date, but limited, as under current law, to the then applicable tax law limitations on benefits and compensation. In no event would the maximum deductible contribution for any plan year be less than the plan's unfunded at-risk liability plus the at-risk normal cost.

Effect of contributing more than the minimum. If a plan sponsor contributes more than the minimum required contribution for the year, the employer will receive a deduction for the year that the contribution is credited for funding purposes, but no adjustment is made to the required contributions under the payment schedules that amortize funding shortfalls. Because contributing more than the minimum amount (and actual earnings thereon) will increase plan assets at the next valuation date, a contribution in excess of the minimum for a year will accelerate the date on which the plan's assets equal or exceed the funding target, after which the only required contributions would be the normal cost.

Further, to the extent that the plan sponsor makes additional contributions for a year so that the market value of the plan's assets at the next valuation date exceed the funding target by more than the normal cost for the next year, the plan sponsor will have the flexibility for that next year to make contributions up to the maximum level and the sponsor will not be required to make any minimum contribution for that year. The flexibility to not make a contribution for a year will continue as long as the plan's assets continue to equal or exceed the sum of the funding target and the applicable normal cost.

The potential for a sponsor to make additional contributions during good economic times (even when the plan's assets exceed its funding target) provides a plan sponsor with the opportunity to build up a cushion that can minimize future minimum contributions in bad years. The sponsor will also have incentives to choose to make contributions to the plan when it has the cash (even if the plan's assets exceed its funding target) in order to obtain a tax deduction and to minimize the risk of having to impose the benefit limitations described below. If an employer makes additional contributions, not only will plan participants have greater funding security, but the employer will have received an early deduction as well as tax shelter for the earnings on the early contribution.

A contribution made within the time for filing tax returns for a taxable year (which is generally not later than 8 ½ months after the end of the taxable year) may be deducted for that taxable year, provided that it does not exceed the maximum deductible amount and is treated as a plan contribution made for the plan year that contains the last day of the taxable year. No other changes would be made in the current law rules relating to the timing of contributions under the minimum funding rules and under the maximum deductible limits, or the coordination of taxable years and plan years.

Form 5500, Schedule B actuarial statement and summary annual report (SAR)

All PBGC-covered, single-employer defined benefit plans would be required to disclose the plan's ongoing liability and at-risk liability in the annual Form 5500 (whether or not the sponsor is financially weak). The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

The SAR would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee.

The due date for furnishing the SAR to participants and beneficiaries for all plans would be accelerated to 15 days after the filing date for the Form 5500. A penalty would be imposed for a plan administrator's failure to furnish a SAR in a timely manner. The participant notice requirement under section 4011 of ERISA would be eliminated and the SAR disclosure used in its place.

In the case of a plan that covers more than 100 participants and that is subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date), the deadline for the Schedule B report of the actuarial statement would be shortened. The due date would be the 15th day of the second month following the close of the plan year (February 15 for a calendar year plan). If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

<u>Eliminate grandfather for pre-1988 floor-offset plans</u>

The PPA 1987 exception for floor-offset arrangements in effect on or before December 17, 1987 would be eliminated. Floor-offset arrangements would be required to reduce their holdings of qualifying employer securities and qualifying employer real property to no more than 10 percent of the total combined assets of the defined benefit plan and the related individual account plan over a period of no more than 7 years. This requirement to dispose of such property would apply on a graduated basis pursuant to regulations.

<u>Meaningful limitations on plans funded below target levels</u>

Revision of current limitations on benefits. The current law limitations prohibiting amendments improving benefits for a plan sponsor in bankruptcy would be retained. The generally applicable prohibition against large benefit increases in plans that are less than 60 percent funded would be replaced by the new rules below. The current law prohibition against lump sum payments (and other forms of accelerated benefit payments, including the purchase of annuities) in the case of a plan with a liquidity shortfall would be retained. These rules would be supplemented by the additional limitations on benefits described below.

Limitation on benefit increases. For a plan where the market value of the plan's assets is less than or equal to 80 percent of the funding target as of the valuation date, no amendment increasing benefits would be permitted, unless the sponsor contributes the sum of the minimum required contribution and the increase in the funding target attributable to the amendment. If the market value of the plan's assets is above 80 percent of the funding target, but was less than 100 percent for the prior plan year, then no benefit increase amendment that would cause the market value of the plan's assets to be less than 80 percent of the funding target would be permitted, unless the sponsor contributes the minimum required contribution plus the increase in the funding target attributable to the amendment (or, if less, the minimum required contribution plus the amount necessary to increase the plan's assets to equal 80 percent of the funding target). For a plan where the market value of the plan's assets was at least 100 percent of the funding target as of the prior year, no limit on benefit increases would apply.

Limitations on accelerated benefit distributions. If either the market value of a plan's assets is less than or equal to 60 percent of the funding target as of the valuation date or the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 80 percent of the funding target as of the valuation date, no lump sum distributions or other accelerated benefit forms would be permitted. The same constraint on lump sum distributions would apply to plans sponsored by employers in bankruptcy, unless the martey value of plan assets is greater than the funding target as of the valuation date.

Limitations on accruals for plans with severe funding shortfalls or sponsors in bankruptcy. If the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 60 percent of the funding target as of the valuation date (i.e., the plan is "severely underfunded"), or for a plan whose sponsor is in bankruptcy and whose assets are less than the funding target as of the valuation date, the plan would be required to be frozen.

Prohibition on funding executive compensation for severely underfunded plans sponsored by financially weak employers and for insufficient plan terminations. If a financially weak employer has a severely underfunded plan, special rules would apply under ERISA that would prohibit the funding of nonqualified deferred compensation for executives. These special rules would also apply to prohibit any funding of executive compensation that occurs less than 6 months before or 6 months after the termination of a plan whose assets are not sufficient to provide all benefits due under the plan.

Under the special rules, a company would not be permitted to devote its resources to fund an executive's nonqualified deferred compensation arrangements through a rabbi trust, insurance policy or other funding mechanism that limits immediate access to such resources by the company or by creditors. The rules would apply to any top executive in any company in the controlled group (or former employee who was a top executive at the time of termination of employment).

Accordingly, a plan would have a right of action under ERISA against any top executive whose nonqualified deferred compensation arrangement was funded during the period of the prohibition. The right would permit recovery of the total amount that was funded, together with attorney's fees. The sponsor of any plan to which these rules apply would be required to notify the plan fiduciaries of its funded deferred compensation arrangements when any funding of deferred compensation arrangements for executives occurs in the case of a plan that is severely underfunded or when the plan terminates. The plan fiduciaries would have access to the company's books to ascertain whether the company met its obligation in this regard. Plan fiduciaries would be obligated, under existing law, to take reasonable steps to pursue the cause of action afforded by this new provision.

New plans. Except for the prohibitions against lump sums and other accelerated benefit forms, the various limitations on benefits and the prohibition on securing executive compensation would not apply for the first five years after a plan is established.

Timing rules to implement limitations. A series of special timing rules apply for determining whether a plan's funding percentage is below one of the thresholds for applying the benefit limitation thresholds described above, based on annual certifications that are to be provided by the plan actuary. If a plan was subject to a benefit limitation in the prior year, then the funding percentage is presumed not to have improved in the current year until the enrolled actuary certifies that the funded status at the valuation date for the current plan year has improved sufficiently so that the benefit limitation does not apply for the current year. If a benefit limitation did not apply in the prior year, but the funding percentage for that year was no more than 10 percentage points above the threshold for applying that benefit limitation, then the plan's funding percentage is automatically presumed to have been reduced by 10 percentage points for the current plan year as of the first day of the 4^{th} month of the plan year (so that the benefit limitation applies for the current year beginning on that day) unless and until the enrolled actuary certifies that the funded status is such that the benefit limitation does not apply for the current year. In any other case, if an actuarial certification fails to be completed by the first day of the 10^{th} month of the plan year, then the plan's funding percentage for the plan year is presumed to not exceed 60 percent for the current year beginning on that day for purposes of the benefit limitations.

With respect to the requirement that a plan be frozen when the sponsor is in bankruptcy if the plan assets are less than the funding target as of the valuation date, an automatic freeze would occur at the time of entering bankruptcy during a plan year unless and until the enrolled actuary certifies that plan assets are at least equal to the funding target as of the valuation date for the plan year. If such a certification is made during the plan year, then the freeze is released retroactively to the valuation date.

For the purpose of these timing rules, the actuary's certification is to be based on information available to the actuary at the time of the certification regarding the market value of plan assets and the actuary's best estimate of the plan's funding target on the valuation date for the current plan year. If the actuary determines that the funded percentage using the actual funding target would result in a change in the application of the benefit limitations, the actuary must notify the plan administrator of the change.

Participant notice of benefit or guarantee limitation. Plans that become subject to benefit limitations or to special limitations on the PBGC guarantee (including plans of sponsors that enter bankruptcy) would be required under ERISA to furnish a related notice to affected participants and beneficiaries. The notice would be required to be furnished within a reasonable time after the date the limitation applies (or, to the extent set forth by the Secretary of Labor, a reasonable period before the limitation applies). A notice also would be required to be furnished within a reasonable time of the date a limitation ceases to apply. A penalty would be imposed under Title I of ERISA for a plan administrator's failure to furnish the required notice. The Secretary of Labor would be authorized to issue regulations describing the form, content, and timing of the notice.

Restoration of plan benefits. Plans that are frozen or for which lump sums or other accelerated benefit forms are prohibited would be permitted to resume accruals and accelerated benefit forms in a subsequent plan year only by a plan amendment. The plan amendment may be adopted at any time after the first valuation date on which the plan's assets exceed the applicable threshold percentage. The plan amendment would be subject to the limitations on benefit increases and also would result in a phase-in of the PBGC guarantee.

Prohibition on plant shutdown benefits

Plans would not be permitted to provide benefits that are payable upon a plant shutdown or any similar unpredictable contingent event as determined under regulations. A plan that contains such a benefit would be required to eliminate the benefit, but only with respect to an event that occurs after the effective date, and such a plan amendment would not violate the anti-cutback rules. If a benefit becomes payable as a result of such a plant shutdown event that occurs after February 1, 2006 and before the effective date for the prohibition, the benefit would not be covered by the PBGC guarantee.

Effective dates

The proposal generally would be effective for plan years beginning in 2006. The new benefit limitations (including the prohibition on unpredictable contingent event benefits) would be effective for plan years beginning in 2008. In the case of a collective bargaining agreement in effect on the date of enactment, the benefit limitations (other than the prohibition on unpredictable contingent event benefits) would not be effective before the end of the term of that agreement (without regard to extensions) or, if earlier, the first plan year beginning in 2010. In the case of a collective bargaining agreement that provided for an unpredictable contingent event benefit on February 1, 2006, the prohibition on unpredictable contingent event benefits would not be effective before the end of the term of that agreement (without regard to extension) or, if earlier, the first plan year beginning in 2009.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	536	2,290	-153	-2,336	-1,611	-1,274	-9,180

REFLECT MARKET INTEREST RATES IN LUMP SUM PAYMENTS

Current Law

In the case of qualified defined benefit plans (other than government plans and certain church plans), the amount of the distribution made in the form of a lump sum must be no less than the actuarial value of the annuity benefit under the plan, determined using a statutorily specified interest rate and mortality table. The same rule also generally applies to other benefit forms that are accelerated in comparison to life annuity payments. The statutorily specified interest rate is the average of the rate of interest on 30-year Treasury securities for the month preceding the distribution or, in accordance with regulations, at some earlier time specified under the plan. As there are no 30-year Treasury securities outstanding, the interest rate on the Treasury bond due February 15, 2031 is used for this purpose.

Reasons for Change

Interest rates used for determining lump sums should accurately reflect the cost of settling the employee's pension. The current use of the rate of interest on 30-year Treasury securities for purposes of determining lump sums creates a mismatch between the amount of an employee's lump sum and the value of the annuity that the employee would otherwise receive. This mismatch may create an incentive for retirees to select one form of benefit payment (a lump sum) rather than an annuity. Changing the interest rate used to determine lump sums to market-determined interest rates that reflect the timing of expected benefit payments would remove this bias and ensure that the amount of the lump sum is the same as the value of the annuity. Any such change should provide a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law.

Proposal

Lump sum calculations would be calculated using interest rates that are drawn from a zero-coupon corporate bond yield curve. The yield curve would be issued monthly by the Secretary of Treasury and would be based on the interest rates (averaged over 90 business days) for high quality corporate bonds with varying maturities. Thus, the interest rates that would apply would depend on how many years in the future a participant's annuity payment will be made. In the usual situation of an upwardly sloping yield curve, higher interest rates would be used to discount annuity payments expected to be made further out in the future, with lower interest rates applying for annuity payments made in the near term.

There would be no change in law relating to the determination of minimum lump sums for distributions in plan years beginning in 2006 and 2007. The new rules would go fully into effect for plan years beginning on or after January 1, 2010 and would be phased in for the plan years that begin in 2008 and 2009. For distributions in plan years beginning in 2008 and 2009, lump sum calculations would be determined as the weighted average of the value of the lump sum determined using current law and the value of the lump sum determined using the methodology applicable to subsequent plan years. For plan years beginning in 2008, the weighting factor would be 2/3 for the “old” methodology and 1/3 for the new methodology; and for plan years beginning in 2009, the weighting factors would be reversed.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	-3	-9	-17	-24	-53	-274

CLOSE LOOPHOLES AND IMPROVE TAX COMPLIANCE

COMBAT ABUSIVE FOREIGN TAX CREDIT TRANSACTIONS

Current Law

In order to prevent the double taxation of a taxpayer's foreign source income – taxation of the same income by the source country where the income is earned and by the United States – taxpayers are permitted a credit for certain foreign taxes. The amount of foreign taxes that may be credited each year generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income. A foreign tax credit for foreign taxes paid with respect to certain income is not permitted unless the taxpayer meets specific holding period requirements. For dividends, the recipient of the dividend generally must have held the stock for more than 15 days (within a 31-day testing period) in the case of common stock and 45 days (within a 91-day testing period) in the case of preferred stock. For withholding taxes on other types of income, the income recipient generally must have held the property for more than 15 days (within a 31-day testing period).

Reasons for Change

The purpose of the foreign tax credit is to eliminate potential double taxation. Transactions structured to exploit the foreign tax credit rules to eliminate tax altogether are not consistent with this purpose of the foreign tax credit provisions. These transactions can involve the inappropriate separation of foreign taxes from the related foreign income. The Treasury Department uses its substantial existing authority under section 901 and other provisions of the Code to address transactions or structures that produce inappropriate foreign tax credit results. However, by clarifying and centralizing regulatory authority in this area, this supplemental grant of regulatory authority would provide greater flexibility in addressing a wide range of transactions and structures.

Proposal

The proposal would grant regulatory authority to the Treasury Department to address transactions that involve inappropriate separation of foreign taxes from the related foreign income in cases where taxes are imposed on any person in respect of income of an entity. Because the types of transactions involved are varied, the regulations could provide for the disallowance of a credit for all or a portion of the foreign taxes, or for the allocation of the foreign taxes among the participants in the transaction in a manner that is more consistent with the underlying economics of the transaction.

The proposal generally would be effective after enactment.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	1	2	2	3	3	11	26

MODIFY THE ACTIVE TRADE OR BUSINESS TEST

Current Law

Section 355 allows corporations to avoid recognizing gain in certain spin-off and split-off transactions provided that, among other things, the active trade or business test is satisfied. The active trade or business test requires that, immediately after the distribution, the distributing corporation and the corporation the stock of which is distributed (the controlled corporation) be engaged in a trade or business that has been actively conducted throughout the 5-year period ending on the date of the distribution. A corporation is treated as engaged in the active conduct of a trade or business only if it is engaged in the active conduct of a trade or business or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged. There is no statutory requirement that a certain percentage of the distributing corporation's or controlled corporation's assets be used in that active trade or business in order for the active trade or business test to be satisfied.

Reasons for Change

The Administration understands that some taxpayers have engaged in transactions involving a non-pro rata distribution in which a corporate shareholder of a distributing corporation receives a distribution of stock of a controlled corporation where the controlled corporation's assets substantially consist of investment assets. The Administration believes that these transactions resemble redemptions for cash.

Proposal

Under the proposal, in the case of a non-pro rata distribution, in order for a corporation to satisfy the active trade or business test, as of the date of the distribution at least 50 percent of its assets, by value, must be used, or held for use, in a trade or business that satisfies the active trade or business test.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	6	8	8	8	8	38	89

IMPOSE PENALTIES ON CHARITIES THAT FAIL TO ENFORCE CONSERVATION EASEMENTS

Current Law

In general, there is a deduction for charitable contributions, subject to certain limitations that depend on the type of taxpayer, property contributed, and charity receiving the contribution. Gifts of partial interests in property generally are not deductible as charitable contributions. However, to encourage donations for conservation purposes, the tax law provides a charitable contribution deduction for certain contributions of partial interests in real property, such as a remainder interest and a restriction (granted in perpetuity) on the use that may be made of the real property. To qualify, the real property interest must be contributed to a qualified organization exclusively for conservation purposes. Conservation purpose is defined as the preservation of land areas for outdoor recreation by, or the education of, the general public; the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; the preservation of open space where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy; or the preservation of an historically important land area or certified historic structure. A contribution is not treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. To qualify to receive such qualified conservation contributions, a charity must have a commitment to protect the conservation purposes of the contribution and have the resources to enforce the restrictions. In addition, in the instrument of conveyance the donor must prohibit the charity from subsequently transferring the easement (or in the case of a remainder interest, the property) unless the charity ensures that the conservation purposes that the contribution was originally intended to advance continue to be carried out.

Reasons for Change

The Treasury Department is concerned that in some cases taxpayers are claiming charitable contribution deductions for contributions of perpetual conservation restrictions, but the charities that receive those contributions are failing to monitor and enforce the conservation restrictions for which charitable contribution deductions were claimed.

Proposal

The proposal would impose significant 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. The amount of the penalty would be determined based on the value of the conservation restriction shown on the appraisal summary provided to the charity by the donor.

The Secretary would be authorized to waive the penalty in certain cases, such as if it is established to the satisfaction of the Secretary that, due to an unexpected change in the conditions surrounding the real property, retention of the restriction is impossible or impractical, the charity receives an amount that reflects the fair market value of the easement, and the proceeds are used by the charity in furtherance of conservation purposes. The Secretary also would be authorized to require such additional reporting as may be necessary or appropriate to ensure that the conservation purposes are protected in perpetuity.

The proposal would be effective for taxable years beginning after December 31, 2005.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	3	8	8	9	9	37	91

ELIMINATE THE SPECIAL EXCLUSION FROM UNRELATED BUSINESS TAXABLE INCOME FOR GAIN OR LOSS ON THE SALE OR EXCHANGE OF CERTAIN BROWNFIELDS

Current Law

In general, an organization that is otherwise exempt from federal income tax is taxed on income from any trade or business regularly carried on by the organization that is not substantially related to the organization's exempt purposes. Gains or losses from the sale, exchange or other disposition of property (other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of the trade or business) generally are excluded from unrelated business taxable income. However, such amounts may be taxable if they are derived from property that is debt-financed. The amount of income that is taxable is determined based on the ratio of the outstanding indebtedness incurred by the organization in acquiring or improving the property to the adjusted basis of the property. The debt-financed income rules do not apply in the case of certain indebtedness, such as indebtedness that is incurred in the performance or exercise of the purpose or function constituting the basis for the organization's exemption.

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 by a tax-exempt organization, whether the properties are held directly or indirectly through a partnership. For property to qualify for the exclusion, the property must be acquired during a five-year period beginning January 1, 2005 and ending December 31, 2009, although the property may be disposed of after that date. Certain certification requirements must be met. In addition, the exempt organization (or the partnership of which it is a partner) must spend a minimum amount on remediation expenses, which may be determined by averaging expenses across multiple qualifying brownfield properties for a period of up to eight years.

The Act also created a special exception to the debt-financed property rules for qualifying brownfield properties. Thus, gain or loss from the sale or exchange of qualifying brownfield properties is not taxed even if the exempt organization (or partnership) incurred debt to acquire or improve the property.

Reasons for Change

The special exclusion adds considerable complexity to the Code and is difficult to administer. In addition, there are concerns about the effectiveness of the provision because there is no limit on the amount of gain that is exempt from unrelated business income tax. The special exclusion could exempt from income tax real estate development considerably beyond mere environmental remediation.

Proposal

The proposal would eliminate this special exclusion effective for taxable years beginning after December 31, 2006.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	2	14	30	43	41	130	201

LIMIT RELATED PARTY INTEREST DEDUCTIONS

Current Law

Section 163(j) of the Code applies to limit the deductibility of certain interest paid by a corporation to related persons ("disqualified interest"). Disqualified interest for these purposes generally means interest paid or accrued by a corporation to a related person if such interest income is not subject to federal income tax. Disqualified interest also includes interest paid or accrued by a corporation to an unrelated person if the underlying indebtedness is guaranteed by a related foreign person or tax exempt organization and such interest is not subject to U.S. withholding tax. The limitations of section 163(j) only apply to a corporation with a debt-to-equity ratio that exceeds 1.5 to 1. If such a corporation has net interest expense that exceeds 50 percent of its adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction), no deduction is allowed for disqualified interest in excess of the 50-percent limit. Interest that is disallowed in a taxable year under section 163(j) may be carried forward for deduction in a future year; there is no time limit on this carryforward. In addition, excess limitation (i.e., the amount by which the corporation's 50-percent limit exceeds its net interest expense for a taxable year) may be carried forward up to three years.

Reasons for Change

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities.

Proposal

Section 163(j) would be revised to tighten the limitation on the deductibility of interest paid to 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.

Pursuant to section 424 of The American Jobs Creation Act of 2004, the Treasury Department is conducting a study of the effectiveness of and deficiencies in the current section 163(j) rules for addressing these income-reduction opportunities. Congress has requested a report regarding this study. Such report may include recommendations for further modifications to these rules to ensure the elimination of inappropriate income-reduction opportunities.

The proposal would be effective on the date of first committee action.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	82	141	148	155	163	689	1,635

CLARIFY AND SIMPLIFY QUALIFIED TUITION PROGRAMS

Current Law

A section 529 program may be a prepaid tuition program or a savings program. Under either type of program, a contributor creates an account for the benefit of a particular designated beneficiary (DB) to provide for the DB's higher education expenses.

Income tax. Earnings in a section 529 account accumulate tax-free. If a distribution is used to pay qualified higher education expenses (qualified expenses), the distribution is tax-free. If a distribution is not used to pay qualified expenses, the earnings portion of the distribution is subject to federal income tax, plus a 10% additional tax (subject to exceptions, including death, disability or receipt of a scholarship). A change in the DB of a section 529 account is not treated as a "distribution" for income tax purposes if the new DB is a member of the old DB's family.

Gift and Generation-Skipping Transfer (GST) Taxes on Contributions. A contribution to a section 529 account is treated as a completed gift of a present interest from the contributor to the DB. Therefore, contributions to a section 529 account qualify for the per-donee annual gift tax exclusion (currently $12,000); gifts sheltered by this exclusion are also exempt from GST tax. A contributor may contribute up to five times the per-donee annual gift tax exclusion to a section 529 account and, for gift and GST tax purposes, treat the contribution as having been made ratably over five years, beginning in the year in which the contribution is made.

Gift and GST Taxes on Distributions. Because a contribution to a section 529 account is treated as a completed gift, a distribution from a section 529 account generally is not subject to gift or GST tax. Those taxes may, however, apply to a change of DB. Gift or GST tax (or both) may be imposed if the new DB is in a generation below that of the former DB, or if the new DB is not a family member of the former DB.

Estate Tax. Section 529 accounts generally are excluded from the gross estate of the contributor (unless the contributor is also the DB). If, however, the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years following the year of the contributor's death are includible in the contributor's gross estate. Amounts distributed on account of the death of the DB are includible in the DB's gross estate.

Reasons for Change

Current law regarding the transfer tax treatment of section 529 accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions. The law should be clarified to provide taxpayers with certainty as to the tax consequences of a transfer and to eliminate the inappropriate imposition of transfer taxes.

In addition, current law creates opportunities for inappropriate use of section 529 programs. For example, taxpayers may seek to avoid gift and GST taxes by changing the DB of existing section 529 accounts. Taxpayers also may seek to use section 529 accounts as retirement accounts with all the tax benefits but none of the restrictions and requirements of qualified retirement accounts.

This proposal would simplify the tax consequences of section 529 accounts and promote utilization of the accounts to save for higher education.

<u>Proposal</u>

As under current law, contributions to section 529 accounts would be treated as completed gifts to the DB, subject to applicable gift and GST taxes. The special five-year allocation rule would continue to apply.

Each section 529 account would have only one contributor. A section 529 program would be permitted to accept contributions to a section 529 account only from the account's contributor (or the contributor's revocable trust) and, to the extent provided by the Secretary in regulations, from other persons in a *de minimis* amount.

The contributor would be permitted to withdraw funds from the account during the contributor's life, subject to income tax on the income portion of the withdrawal. An additional tax also would apply to the income portion of a withdrawal by the contributor, unless the withdrawal is due to the DB's death, disability, receipt of a scholarship or attendance at a U.S. military academy. The amount of the additional tax generally would be 10% on the income portion of the withdrawal. If a withdrawal occurs more than twenty years after the account was originally created, the additional tax on the earnings portion of that withdrawal would be increased from 10% to 20%.

The contributor would have the ability to name another person to administer the account (the account administrator). The account administrator would have no beneficial interest in the account. The account administrator would be permitted to change the DB from time to time. Neither the account administrator nor the account administrator's spouse would be permitted to be or become a DB of the account, except as provided by the Secretary in regulations.

Except for withdrawals by the contributor, distributions from a section 529 account would be permitted to be made only to or for the benefit of the DB. Distributions used for the DB's qualified expenses would not trigger income tax. As under current law, a DB would be subject to income tax on the accrued income portion of any distribution not used for qualified expenses (a nonqualified distribution).

The income portion of a nonqualified distribution to a DB (or a deceased DB's estate) also would be subject to a 10% additional tax unless this tax would not have applied under current law (which exempts distributions made due to the DB's death, disability, receipt of a scholarship or attendance at a U.S. military academy).

No transfer tax or income tax would be imposed by reason of a change of DB and there would be no limit on the age of a DB. However, a new excise tax payable from the account would apply 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 not apply to a distribution made to a deceased DB's estate. The excise tax would eliminate the potential transfer tax benefit of using a section 529 account for purposes not intended by the statute. 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. The excise tax would be withheld by the section 529 program administrator and paid directly to the Internal Revenue Service, unless the account administrator or the DB provides a certification to the section 529 program administrator establishing that the current distribution is not subject to the excise tax. For purposes of this withholding and payment requirement, the section 529 program administrator would be allowed to rely on these certifications. To the extent this excise tax applies to a nonqualified distribution, the 10% additional tax on the income portion discussed above would not apply to that distribution.

As under current law, a contributor's gross estate would include only the per-donee annual gift tax exclusion used for calendar years after the year of the contributor's death. However, upon the 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 529 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.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	4	12	13	14	20	63	222

TAX ADMINISTRATION AND UNEMPLOYMENT INSURANCE

Improve Tax Administration

IMPLEMENT IRS ADMINISTRATIVE REFORMS AND INITIATE COST SAVINGS MEASURES

Make Section 1203 of the IRS Restructuring and Reform Act of 1998 more effective and fair

Current Law

Section 1203 of the IRS Restructuring and Reform Act of 1998 (RRA98) requires the Commissioner of Internal Revenue to terminate an employee for certain specifically enumerated violations committed by the employee in connection with the performance of the employee's official duties. The Commissioner has non-delegable authority to determine whether mitigating factors support a personnel action other than termination for a covered violation.

Reasons for Change

The Administration's proposal would enhance the IRS' effectiveness by more carefully tailoring the types of conduct by IRS employees that are subject to sanctions, by reinforcing the seriousness with which covered violations will be handled, by providing clear guidance to IRS employees regarding covered conduct and associated penalties, and by allowing the imposition of penalties that are commensurate with specific violations.

Current law requires the termination of an IRS employee for the failure to timely file tax returns, except when such failure is due to reasonable cause and not due to willful neglect. An IRS employee who fails to timely file a refund return (i.e., for a tax year in which the employee is entitled to a refund) is subject to termination even though a taxpayer who files a refund return late generally is not subject to any penalty. Late-filed refund return cases constitute a significant percentage of the section 1203 cases handled to date. These cases do not represent the type of serious conduct for which termination under section 1203 should apply. In addition, a number of section 1203 cases have involved allegations of wrongful conduct by IRS employees against other IRS employees. The Treasury Inspector General for Tax Administration has recommended that these types of cases be removed from the list of violations covered by section 1203. Such allegations can be addressed by existing administrative and statutory procedures. The Administration's proposal would eliminate late refund returns and employee vs. employee acts from the list of covered violations. The proposal also would strengthen taxpayer protections by enhancing the Commissioner's ability to punish the unauthorized access of taxpayer return information.

Current law requires termination for any covered violation unless the Commissioner personally determines that mitigating factors justify some other personnel action. The proposal would require the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of covered violations. These guidelines will provide notice to IRS employees of the punishment that would result from specific violations. This change would improve IRS employee morale and enhance the fundamental fairness of the statute.

Proposal

The Administration's proposal would modify section 1203 of RRA98 by (i) removing the late-filing of refund returns from the list of violations; (ii) removing employee vs. employee acts (i.e., for violation of an employee's, rather than a taxpayer's, Constitutional or civil rights) from the list of violations; and (iii) adding the unauthorized inspection of returns or return information to the list of violations. In addition, the proposal would require the Commissioner to establish guidelines outlining specific penalties, up to and including termination, for specific types of wrongful conduct covered by section 1203 of RRA98. The Commissioner would retain the non-delegable authority to determine whether mitigating factors support a personnel action other than that specified in the guidelines for a covered violation.

The proposal would be effective upon enactment.

Revenue Estimate

[No revenue effect]

Curb the use of frivolous submissions and filings made to impede or delay tax administration

Current Law

The IRS may assert a penalty of $500 on an individual who files an income tax return that, first, either does not contain sufficient information to allow the IRS to determine whether the tax shown on the return is correct or contains information indicating that the tax shown is substantially incorrect and, second, was filed based on a position that is frivolous or, based on information on the return, was intended to delay or impede tax administration.

Reasons for Change

The IRS has been faced with a significant number of individuals who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. In addition, taxpayers are using existing procedures for collection due process (CDP) hearings, offers in compromise, and installment agreements to impede or delay tax administration by raising frivolous arguments. The IRS generally must address such frivolous arguments through mandated procedures, which results in delay and additional administrative burden and expense. Allowing the IRS to assert more substantial penalties for frivolous submissions, and to dismiss frivolous requests without the need to follow otherwise mandated procedures, would deter egregious taxpayer behavior and enable the IRS to utilize its resources more efficiently.

Proposal

The Administration's proposal would increase the penalty for filing frivolous income tax returns from $500 to $5,000. In addition, the proposal would permit the IRS to dismiss requests for CDP hearings, installment agreements, and offers in compromise if they are based on frivolous arguments or are intended to delay or impede tax administration. Individuals submitting such requests would be subject to a $5,000 penalty for repeat behavior or failure to withdraw the request after being given the opportunity to do so. The IRS would be permitted to maintain administrative records of frivolous submissions by taxpayers. However, the IRS would be required to remove the designation of a taxpayer if, after a reasonable period of time, no further frivolous submissions are made by the taxpayer. Finally, the proposal would require the IRS to publish, at least annually, a listing of positions, arguments, requests, and proposals deemed frivolous for purposes of non-return submissions covered by the provision.

The proposal would be effective for submissions made on or after the date of enactment.

Revenue Estimate

[No revenue effect]

Allow for the termination of installment agreements for failure to file returns and for failure to make deposits

Current Law

The IRS may terminate an agreement with a taxpayer to pay a tax liability in installments only for specific statutory reasons. These statutory reasons do not include a taxpayer's failure to file required returns or a taxpayer's failure to make required tax deposits.

Reasons for Change

IRS administrative procedures specify that installment agreements contain a provision requiring taxpayers to meet all return filing and deposit obligations during the term of the agreement. This provision is intended to ensure that the privilege of paying a tax liability in installments is extended only to those taxpayers willing to commit to future compliance. The installment agreement statute, however, does not allow the IRS to terminate an agreement even if a taxpayer fails to file required returns or fails to make required federal tax deposits. Thus, the taxpayer may incur significant additional unpaid tax liability before the IRS can terminate the agreement.

Proposal

The Administration's proposal would permit the IRS to terminate an installment agreement if a taxpayer fails to timely file tax returns or if a taxpayer fails to timely make required federal tax deposits.

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

Revenue Estimate

[No revenue effect]

Consolidate judicial review of collection due process cases in the United States Tax Court

Current Law

The collection due process (CDP) statutes generally entitle taxpayers to notice and a right to a CDP hearing with the IRS Office of Appeals (Appeals) after the filing of a notice of federal tax lien and prior to an intended levy. The taxpayer may request judicial review of a determination by Appeals. The CDP statutes currently provide that venue for the review of an Appeals determination in a CDP case depends on which court (i.e., Tax Court or district court) would have jurisdiction over the underlying tax. Under this rule, the Tax Court reviews CDP cases involving deficiency-type taxes, generally income and estate taxes. The district court reviews CDP cases involving nondeficiency-type taxes, generally employment and excise taxes.

Reasons for Change

The current CDP statutes, which divide responsibility for judicial review between the Tax Court and district courts, were intended to give jurisdiction to the court that would have the most expertise over the underlying tax. In practice, however, taxpayer challenges in CDP cases have focused primarily on collection issues rather than liability issues. In particular, relatively few district court CDP cases have involved challenges to the underlying tax liability. The division of jurisdiction between the Tax Court and the district courts has needlessly complicated the CDP process by making it more confusing and expensive for taxpayers. A taxpayer who files a request for review with the wrong court must incur the expense of refiling the case in the correct court. In certain circumstances, a taxpayer may be required to seek judicial review in both the Tax Court and a district court. In addition, there are indications that some taxpayers are using the CDP venue provisions to delay collection activity by deliberately filing the case with the wrong court. Most cases seeking judicial review of Appeals determinations in CDP cases already are handled by the Tax Court. This proposal not only will simplify and streamline the CDP process for taxpayers, but will also enable the Government and taxpayers to benefit from the Tax Court's expertise in CDP issues.

Proposal

The Administration's proposal would provide that the United States Tax Court shall be the exclusive venue for suits to obtain judicial review of any determination issued by Appeals after a CDP hearing. The proposal would be effective for Appeals determinations made after the date of enactment.

Revenue Estimate

[No revenue effect]

Eliminate the monetary threshold for counsel review of offers in compromise

Current Law

Whenever a compromise is reached between the IRS and a taxpayer under section 7122, a record of the compromise must be placed on file along with an opinion from the IRS Office of Chief Counsel. The opinion of Chief Counsel is not required when the total liability, including penalties and interest, is less than $50,000. All compromises, regardless of amount, are subject to continuous quality review by the Secretary.

Reasons for Change

The Administration's proposal would allow the IRS to more efficiently direct resources for offer in compromise (OIC) cases while retaining existing quality review procedures. Many OIC cases do not present any significant legal issues, and the required legal review for cases meeting the statutory threshold can delay the acceptance process under current administrative procedures. The proposal would require the establishment of criteria for determining when review by Chief Counsel is appropriate. By retaining the requirement of continuous quality review by the Secretary, this proposal would insure that the overall quality of case dispositions does not decline.

Proposal

The Administration's proposal would eliminate the requirement that the opinion of Chief Counsel be placed on file for any accepted offer in compromise involving unpaid taxes, penalties, and interest equal to or exceeding $50,000. This proposal would require the Secretary to establish standards for determining when an opinion of Chief Counsel must be obtained. The proposal would be effective for offers in compromise submitted or pending on or after the date of enactment.

Revenue Estimate

[No revenue effect]

Allow the Financial Management Service to retain transaction fees from levied amounts

Current Law

The IRS may continuously levy up to 100 percent of certain federal payments to a delinquent taxpayer under the Federal Payment Levy Program (FPLP). The FPLP is administered by the Financial Management Service (FMS) of the Department of the Treasury. FMS charges the IRS the costs incurred in developing and operating the FPLP. For the current fiscal year, the IRS expects that the FPLP fees charged by FMS will be between $11 and $12 million.

Reasons for Change

The IRS pays the FPLP fees to FMS out of the IRS' own appropriations. The FPLP fees have increased since the inception of the program due to increased FMS costs and increased use of the FPLP program. The proposal would alter internal government accounting to effectively eliminate accounting costs.

Proposal

The Administration's proposal would allow FMS to retain directly a portion of the levied funds as payment for FMS' fees. A delinquent taxpayer, however, would receive full credit for the amount levied upon – i.e., the amount credited to a taxpayer's account would not be reduced by FMS' fee. The proposal would be effective upon enactment.

Revenue Estimate

[No revenue effect]

Expand the authority to require electronic filing by large businesses and exempt organizations

Current Law

The Secretary may require electronic filing by taxpayers (other than individuals, estates and trusts) that file at least 250 returns annually. Before requiring electronic filing, the Secretary must take into account the ability of taxpayers to comply at a reasonable cost. Partnerships that have more than 100 partners are required to file their returns electronically.

Reasons for Change

Electronic filing benefits taxpayers by improving the accuracy of filed returns, providing an acknowledgement that the return has been received by the IRS, and speeding the processing of refunds. Electronic filing also benefits the government through reduced processing costs. Congress established a goal of having at least 80 percent of all federal tax and information returns filed electronically by 2007.

Although almost all businesses and exempt organizations prepare their returns electronically, many submit them in paper form to the IRS. Most businesses and organizations have the ability to file returns electronically at a small additional cost. By expanding the authority to require more businesses and exempt organizations to file their returns electronically, additional progress can be made toward achieving the goal of having 80 percent of all returns filed electronically by 2007.

Proposal

The Administration's proposal would expand the Secretary's authority to require businesses (including corporations, partnerships and other business entities) and exempt organizations to file their returns electronically. The Administration's proposal would lower 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. Before implementing any new electronic filing requirement, the Secretary would take into account the ability of taxpayers to comply at a reasonable cost and would balance the benefits of electronic filing against any burdens that might be imposed on taxpayers. The Administration's proposal also would require the Secretary to implement the expanded electronic filing authority incrementally in order to provide taxpayers with adequate time to prepare to file their returns electronically. Taxpayers that fail to file their returns electronically when required would be subject to a monetary penalty. The penalty could be waived if the taxpayer had reasonable cause for failing to file electronically. The proposal would be effective for taxable years beginning after December 31, 2006.

Revenue Estimate

[No revenue effect]

Allow IRS to access information in the National Directory of New Hires for tax administration purposes

Current Law

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: newly-hired employee data from Form W-4; quarterly wage data from state and federal employment security agencies; and 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.

Under current provisions of the Social Security Act, the IRS may obtain data from the NDNH, but only for the purpose of administering the Earned Income Tax Credit (EITC) and verifying employment reported on a tax return.

Generally, the IRS obtains employment and unemployment data less frequently than quarterly, and there are significant internal costs of preparing these data for use. Under various state laws, the IRS may negotiate for access to employment and unemployment data directly from state agencies that maintain these data.

Reasons for Change

Employment data are useful to the IRS in administering a wide range of tax provisions beyond the EITC, including verifying taxpayer claims and identifying levy sources. Currently, the IRS may obtain employment and unemployment data on a state-by-state basis, which is a costly and time-consuming process. NDNH data are timely, uniformly compiled, and electronically accessible. Access to the NDNH would increase the productivity of the IRS by reducing the amount of IRS resources dedicated to obtaining and processing data without reducing the current levels of taxpayer privacy.

Proposal

The Social Security Act would be amended to allow the IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for non-compliant taxpayers, and identification of levy sources. Data obtained by the IRS from the NDNH would be protected by existing taxpayer privacy law, including civil and criminal sanctions. The proposal would be effective upon enactment.

Revenue Estimate

[No revenue effect]

Extend IRS authority to fund undercover operations

Current Law

The IRS is authorized to use proceeds it receives from undercover operations to offset necessary and reasonable expenses incurred in such operations. The IRS' authority to use proceeds from undercover operations is scheduled to expire on December 31, 2006.

Reasons for Change

The IRS' authority to use proceeds from undercover operations places the IRS on equal footing with other federal law enforcement agencies. The IRS uses this authority to facilitate long-term, complicated criminal investigations, including investigations of international money laundering activities that often are connected to terrorism. The expiration of this authority would disrupt ongoing investigations. An extension would preserve the IRS' ability to pursue these important criminal investigations.

Proposal

The proposal would extend the IRS' authority to use the proceeds received from undercover operations through December 31, 2011.

Revenue Estimate

[No revenue effect]

REDUCE THE TAX GAP

In March 2005, the IRS released preliminary results from a major new research project assessing compliance with the tax laws by individual taxpayers. The research project confirmed that the vast majority of Americans pay their taxes timely and accurately, but also confirmed that a significant gap persists between what should be paid in taxes and what is actually paid. The Administration's Budget makes five proposals that, if enacted, would help to address this tax gap. In addition to these five proposals, the Treasury Department will continue to consider other ways to close the tax gap and, in particular, will study the standards used to distinguish between employees and independent contractors for purposes of withholding and paying Federal employment taxes.

Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes

Current Law

Employers are required to withhold and pay Federal Insurance Contribution Act (FICA) and income taxes, and are required to pay Federal Unemployment Tax Act (FUTA) taxes (collectively "Federal employment taxes") with respect to wages paid to their employees. Liability for Federal employment taxes generally lies with the taxpayer that is determined to be the employer under a multi-factor common law test or under specific statutory provisions. For example, a third party that is not the common law employer can be a statutory employer if the third party has control over the payment of wages. In addition, certain designated agents are jointly and severally liable with their principals for employment taxes with respect to wages paid to the principals' employees. These designated agents prepare and file employment tax returns using their own name and employer identification number. In contrast, reporting agents (often referred to as payroll service providers) are generally not liable for the employment taxes reported on their clients' returns. Reporting agents prepare and file employment tax returns for their clients using the client's name and employer identification number.

Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Employee leasing companies (often referred to as professional employer organizations) typically prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of their clients' workers.

Reasons for Change

Non-compliance with Federal employment tax reporting and withholding requirements is a significant part of the tax gap. The tax gap undermines confidence in the fairness of our tax administration system and fosters noncompliance. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to wages paid by a taxpayer that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

Providing standards for when an employee leasing company and its clients will be held liable for Federal employment taxes will facilitate the assessment, payment and collection of those taxes and will preclude taxpayers who have control over withholding and payment of those taxes from denying liability when the taxes are not paid.

Proposal

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also provide standards for holding employee leasing companies solely liable for such taxes if they meet specified requirements.

The provision would be effective for employment tax returns filed with respect to wages paid on or after January 1, 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	3	5	5	5	6	24	57

Increased information reporting on payment card transactions

Current Law

Businesses, governments, and other taxpayers are subject to a number of information reporting and withholding requirements. For example, every person engaged in a trade or business must generally file information returns each year for payments of $600 or more made in the course of that trade or business in a calendar year. In addition, any service recipient engaged in a trade or business is required to file an information return when the aggregate of payments for services is $600 or more in a calendar year. Payments made in the course of a trade or business that are subject to information reporting are generally subject to backup withholding if the payee fails to provide a taxpayer identification number (TIN), or if the IRS notifies the payor that the TIN furnished by the payee is incorrect.

Reasons for Change

Payment cards (both credit cards and debit cards) are a growing form of payment for retail business transactions. The failure of some retail businesses to accurately report their gross income, including income derived from payment card transactions, represents a significant part of the tax gap. The tax gap undermines confidence in the fairness of the tax administration system and fosters noncompliance. Increased information reporting and backup withholding have been shown to be highly effective in improving compliance. Because payment card issuers already track payment information and provide it to merchants, requiring reimbursement information to be provided to the IRS, on an aggregate annual basis, will impose a minimal burden on card issuers. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers, without imposing a significant burden on card issuers.

Proposal

The proposal would provide the Secretary with authority to promulgate regulations requiring payment card issuers to report to the IRS annually the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding for card issuers in the event that a merchant payee fails to provide a TIN, or if the IRS notifies the payor that the TIN furnished by the payee is incorrect. It is expected that, as under current information reporting regulations, certain categories of merchant payees, such as corporations, would be excluded from the reporting and backup withholding requirements. It is also expected that certain categories of payments would be excluded from the reporting and backup withholding requirements.

The proposal would be effective for payments made by payment card issuers on or after January 1, 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	9	20	20	21	22	92	225

Require increased information reporting for certain government payments for goods and services

Current Law

Businesses, governments, and other taxpayers are subject to a number of information reporting and withholding requirements. For example, every person engaged in a trade or business must generally file information returns each year for payments of $600 or more made in the course of that trade or business in a calendar year. In addition, any service recipient engaged in a trade or business is required to file an information return when the aggregate of payments for services is $600 or more in a calendar year. Payments made in the course of a trade or business that are subject to information reporting are generally subject to backup withholding if the payee fails to provide a taxpayer identification number (TIN), or if the IRS notifies the payor that the TIN furnished by the payee is incorrect.

Reasons for Change

The failure of some government vendors to meet their tax filing and payment obligations is a particularly egregious component of the tax gap. The tax gap undermines confidence in the fairness of our tax system and fosters noncompliance.

Increased information reporting and backup withholding have been shown to be highly effective in improving compliance. Payments subject to information reporting and backup withholding have a much lower misreporting percentage than payments that are not subject to any information reporting at all.

Proposal

The Administration's proposal would authorize the Secretary to promulgate regulations requiring information reporting and backup withholding on all non-wage payments by Federal, state and local governments to procure property and services. It is expected that certain categories of payments would be excluded from the new information reporting and withholding requirements, including payments of interest, payments for real property, payments to tax-exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The proposal would be effective for payments made on or after January 1, 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	84	172	181	190	201	828	2,000

Amend collection due process procedures for employment tax liabilities

Current Law

Employers are required to withhold and pay Federal Insurance Contribution Act (FICA) taxes and income taxes, and are required to pay Federal Unemployment Tax Act (FUTA) taxes (collectively "Federal employment taxes") with respect to wages paid to their employees. Employers are generally required to file annual returns (Form 940) reporting FUTA taxes and are generally required to file quarterly returns (Form 941) reporting FICA taxes and income tax withholding. For small employers, the taxes reported on Form 941 are generally required to be deposited on a monthly or semi-weekly basis.

In order to ensure the payment and collection of employment taxes, the IRS is authorized to take various collection actions, including issuing Federal tax levies. Before a tax levy can be issued, however, the IRS must generally provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review. An exception to the requirement for pre-levy CDP proceedings applies to levies issued to collect a Federal tax liability from a State tax refund. In this context, the taxpayer is provided an opportunity for a CDP hearing within a reasonable period of time after the levy.

Reasons for Change

Employment taxes represent nearly one-fifth of the IRS total inventory of unpaid taxes. Frequently, an employer that fails to satisfy its Federal employment tax liabilities for one period will also fail to satisfy its liabilities for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing and judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for these subsequent periods cannot be collected by levy until after the employer has been given notice and opportunity for hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by allowing employers to continue to accrue Federal employment tax obligations without risk of collection action.

Proposal

The proposal would expand the exception to the requirement for pre-levy CDP proceedings to include levies issued to collect Federal employment taxes. As with the current procedures applicable to levies issued to collect a Federal tax liability from State tax refunds, the taxpayer would be provided an opportunity for a CDP hearing within a reasonable period of time after the levy. Collection by levy would be allowed to continue during the CDP proceedings. Taxpayers would retain their current right to seek managerial appeal of a proposed levy and to participate in the formal Collection Appeals Process before a levy is issued.

The proposal would be effective for levies issued on or after January 1, 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	140	86	33	16	14	289	364

Expand the signature requirement and penalty provisions applicable to paid tax return preparers

Current Law

Tax return preparers are required to sign and include their taxpayer identification numbers (TINs) on income tax returns and income tax return-related documents that they prepare for compensation. Penalties apply to the failure of a return preparer to sign and include a TIN on these documents. Paid return preparers are not required to sign and include their TINs on non-income tax returns and non-income tax return-related documents, such as employment tax returns, excise tax returns, estate and gift tax returns, or other documents submitted to the IRS with respect to taxes other than income taxes. Accordingly, paid preparers are not subject to penalties for failing to sign or include their TIN on these documents.

Reasons for Change

Unscrupulous return preparers contribute to the tax gap by facilitating the reporting of unreasonable and unrealistic positions on tax returns. The current law requirement for paid preparers to sign and include their TINs on income tax returns and income tax return-related documents, and the related penalty provision, helps to ensure the accountability of paid return preparers. Expanding these provisions to non-income tax returns and related documents will help to ensure the accountability of return preparers in these other contexts.

Proposal

The proposal would expand preparer identification and penalty provisions to non-income tax returns and non-income tax return-related documents prepared for compensation. In addition, it would subject paid preparers to penalties for preparing non-income tax return-related documents that contain false, incomplete, or misleading information or contain frivolous positions that delay collection.

The proposal would be effective for returns filed on or after January 1, 2007.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
0	23	68	72	64	65	292	914

Strengthen Financial Integrity of Unemployment Insurance

STRENGTHEN THE FINANCIAL INTEGRITY OF THE UNEMPLOYMENT INSURANCE SYSTEM BY REDUCING IMPROPER BENEFIT PAYMENTS AND TAX AVOIDANCE

Current Law

The Federal Unemployment Tax Act (FUTA) currently imposes a Federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. Generally, these funds support the administrative costs of the unemployment insurance system. Employers in states that meet certain Federal requirements are allowed a credit against FUTA taxes of up to 5.4 percent, making the minimum net Federal rate 0.8 percent. States also impose an unemployment tax on employers. A state's unemployment insurance taxes are first placed in the state's own clearing account and then deposited into its Federal unemployment insurance trust fund from which the state pays unemployment benefits. State recoveries of overpayments of unemployment insurance benefits must be similarly deposited and used exclusively to pay unemployment benefits.

While states may enact penalties for overpayments, amounts collected as penalties or interest on benefit overpayments may be treated as general receipts by the states.

Reasons for Change

States' abilities to reduce overpayments and increase overpayment recoveries are limited by funding. The mandatory redeposit of the collection of unemployment benefits overpayments prevents states from redirecting these amounts to future recovery activity. The mandatory redeposit rule also limits the ability of states to use private collection agencies. Although states might use penalties or interest on overpayments to increase collections, there is no requirement that such amounts be directed for additional enforcement activities.

Proposal

The proposal would increase incentives for the recovery of state unemployment benefit overpayments and delinquent employer taxes. The proposal would allow states to redirect up to 5 percent of overpayment recoveries to additional enforcement activity. The proposal would require states to impose a penalty of at least 15 percent on recipients of fraudulent overpayments, and penalty revenue would be used exclusively for additional enforcement activity. States would be prohibited from relieving an employer of benefit charges due to a benefit overpayment if the employer had caused the overpayment. In certain circumstances relating to fraudulent overpayment of delinquent employer taxes, states would be allowed to permit private collection agencies to retain a portion (up to 25 percent) of any amounts collected. At the request of a state, the Secretary of the Treasury would collect benefit overpayments due to a state from any income tax refund owed to a benefit recipient. The proposal would allow states to deposit up to 5 percent of moneys recovered in the course of a UI tax investigation into a special fund dedicated to implementing the State Unemployment Tax Act (SUTA) Dumping Prevention Act of 2004 or enforcing state laws relating to employer fraud or tax evasion. The proposal would require employers to report a “start work date” to the National Directory of New Hires for all new hires. Finally, the proposal would authorize the Secretary of Labor to waive certain requirements to allow states to conduct Demonstration Projects geared to reemployment of individuals eligible for unemployment benefits.

The provisions of the act would be effective as of the date of enactment.

Revenue Estimate[24]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	31	30	-106	-143	-188	-2,246

[24] Net of income offsets

EXTEND UNEMPLOYMENT INSURANCE SURTAX

Current Law

The Federal Unemployment Tax Act (FUTA) currently imposes a Federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the Federal/State unemployment benefits system. This 6.2 percent rate includes a temporary surtax of 0.2 percent. States also impose an unemployment tax on employers. Employers in States that meet certain Federal requirements are allowed a credit for State unemployment taxes of up to 5.4 percent, making the minimum net Federal tax rate 0.8 percent. Generally, Federal and State unemployment taxes are collected quarterly and deposited in Federal trust fund accounts.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and temporary surtax rate of 0.2 percent. The surtax has been extended several times, the most recently through 2007, to build up reserves in the Federal trust accounts and thus to help avoid future funding problems in these accounts.

Reasons for Change

Extending the surtax will support the continued solvency of the Federal unemployment trust funds and maintain the ability of the unemployment system to adjust to any economic downturns.

Proposal

The proposal would extend the 0.2 percent surtax through December 31, 2012.

Revenue Estimate[25]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	1,085	1,490	1,526	1,564	5,665	710

[25] Net of income offsets

MODIFY ENERGY POLICY ACT OF 2005

REPEAL REDUCED RECOVERY PERIOD FOR NATURAL GAS DISTRIBUTION LINES

Current Law

Pipelines used by utilities to distribute natural gas to their customers (natural gas distribution lines) placed in service before January 1, 2011, are assigned a statutory recovery period of 15 years for purposes of the Modified Accelerated Cost Recovery System (MACRS) and a statutory class life of 35 years for purposes of the alternative depreciation system applicable to certain property and for purposes of computing the alternative minimum tax. Natural gas distribution lines placed in service after December 31, 2010, are assigned a 20-year recovery period for purposes of MACRS and a 35-year class life for purposes of the alternative depreciation system.

Reasons for Change

Because the 15-year MACRS recovery period for natural gas distribution lines benefits gas utilities rather than gas producers, it does not significantly add to our nation's energy supplies over what the market would provide if the recovery period were 20 years. Moreover, the 15-year recovery period provides natural gas utilities with an unwarranted advantage over competitors such as electric utilities.

Proposal

The Administration's proposal would assign natural gas distribution lines a statutory recovery period of 20 years for purposes of MACRS. The 35-year class life for purposes of the alternative depreciation system would be retained. The proposal would be effective for natural gas distribution lines placed in service after December 31, 2006.

Revenue Estimate

			Fiscal Years				
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
			($ in millions)				
--	12	44	80	112	125	373	833

MODIFY AMORTIZATION FOR CERTAIN GEOLOGICAL AND GEOPHYSICAL EXPENDITURES

Current Law

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. Geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States are amortized over two years.

Reasons for Change

Current high energy prices are already providing significant incentives for companies to invest in oil and gas exploration. The Energy Act provisions expanding tax incentives for oil and gas exploration are not necessary.

Proposal

The Administration's proposal would establish a five-year amortization period for geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States. Five-year amortization would apply even if the property is abandoned and any remaining basis of the abandoned property would be recovered over the remainder of the five-year period. The proposal would be effective for amounts paid or incurred in taxable years beginning after December 31, 2006.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	38	140	206	169	88	641	730

EXTEND EXPIRING PROVISIONS

MINIMUM TAX RELIEF FOR INDIVIDUALS

Current Law

An individual is subject to an alternative minimum tax (AMT) to the extent the individual's tentative minimum tax is greater than the regular tax liability. In computing the tentative minimum tax, taxable income is calculated differently than for regular tax purposes. Under the AMT, certain income items are included that are not included for regular tax purposes. Also, certain deductions, including state and local tax deductions, miscellaneous itemized deductions, and the standard deduction, are not permitted. A specified exemption amount, which varies by filing status but not by the number of personal exemptions and which phases out at higher income levels, is allowed. The regular tax personal exemptions for taxpayers and their dependents are not allowed in computing the AMT. Under the AMT, the tax rate is 26 percent on the first $175,000 ($87,500 if married filing separately) of AMT income, and 28 percent on any excess.

Generally, for AMT purposes taxpayers are allowed to use most tax credits only to the extent their regular tax liability exceeds their tentative minimum tax. However, under provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), before 2011, the child tax credit, the adoption credit, and the saver's credit are not limited by the AMT, and the AMT does not reduce the earned income tax credit and the additional child tax credit. A temporary provision, which permitted an individual to reduce tax liability by the full amount of nonrefundable personal credits (such as the child and dependent care credit and the higher education credits) even if tax liability is reduced to an amount that is less than the individual's tentative minimum tax, expired after taxable year 2001 but was extended for taxable years 2002 and 2003 by the Job Creation and Worker Assistance Act of 2002 and for 2004 and 2005 by the Working Families Tax Relief Act of 2004.

EGTRRA increased the alternative minimum tax (AMT) exemption amounts for taxable years 2001 through 2004, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) further increased the exemptions for 2003 and 2004, and the Working Families Tax Relief Act of 2004 extended the higher exemption amount through 2005. Through 2005, the exemption level was $40,250 for single and head of household filers, $58,000 for married taxpayers filing joint returns, and $29,000 for married taxpayers filing separate returns. Beginning in taxable year 2005, the exemption levels revert to their pre-EGTRRA levels of $33,750, $45,000, and $22,500, respectively.

Reasons for Change

The Administration is concerned that the individual AMT may impose substantial burdens upon taxpayers who were not the originally intended targets of the individual AMT. Allowing the higher AMT exemption levels and nonrefundable personal credits to be used in full for an additional year would avoid a significant increase in the number of taxpayers subject to the AMT in the near term. Substantially fewer taxpayers would need to perform the complex and tedious

AMT computations. The Administration believes the longer term solution to the problems associated with the individual AMT is best addressed within the context of fundamental tax reform.

Proposal

The proposal would continue the higher AMT exemption levels 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.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-13,664	-20,495	--	--	--	--	-20,495	-20,495

RESEARCH & EXPERIMENTATION (R&E) TAX CREDIT

Current Law

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 tax credit expired on December 31, 2005.

Reasons for Change

The R&E tax credit encourages technological developments that are an important component of economic growth. However, uncertainty about the future availability of the R&E tax credit diminishes the incentive effect of the credit because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. To improve the credit's effectiveness, the R&E tax credit should be made permanent.

Proposal

The proposal would make permanent, effective January 1, 2006, the 20-percent tax credit (for qualified research and experimentation expenditures above a base amount) and the alternative credit.

In addition, the Administration is concerned that features of the R&E tax credit may limit its effectiveness in encouraging taxpayers to invest in R&E. The Administration will work closely with the Congress to develop and enact reforms to rationalize the R&E tax credit and improve its incentive effect.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-2,097	-4,601	-5,944	-6,889	-7,669	-8,340	-33,443	-86,440

COMBINED WORK OPPORTUNITY / WELFARE-TO-WORK TAX CREDIT

Current Law

Under current law, employers are generally entitled to a work opportunity tax credit (WOTC) for the first $6,000 of cash wages paid to several target groups of economically disadvantaged or handicapped workers. The maximum WOTC credit is generally $2,400 per worker. For the summer youth target group, the credit is limited to the first $3,000 of cash wages and the maximum credit is $1,200. For workers employed between 120 and 400 hours, the WOTC credit rate is 25 percent of qualified wages. For workers employed over 400 hours, the WOTC credit rate is 40 percent. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The minimum employment period that employees must work before employers can claim the WOTC credit is 120 hours.

The welfare-to-work (WTW) tax credit enables employers to claim a tax credit for eligible wages paid to certain qualified long-term welfare recipients. The WTW credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. Thus, the maximum credit is $8,500 per qualified employee. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The minimum employment period that employees must work before employers can claim the WTW credit is 400 hours.

Other limitations, including the tax liability limitations governing the general business credit, restrict the amount of WOTC and WTW credits that can be claimed.

Current WOTC target groups include qualified: (1) recipients of Temporary Assistance to Needy Families (TANF); (2) veterans; (3) ex-felons; (4) high-risk youth; (5) participants in state-sponsored vocational rehabilitation programs; (6) summer youth; (7) food stamp recipients; and (8) Supplemental Security Income (SSI) recipients. A qualified long-term welfare recipient for purposes of the WTW credit is: (1) a member of a family that has received TANF for at least 18 consecutive months ending on the hiring date; (2) a member of a family that has received TANF for a total of 18 months after August 5, 1997, provided the hiring date is within two years of the date when the 18-month total is reached; or (3) a member of family ineligible for TANF because of any federal- or state-imposed time limit, if the family member is hired within two years of the date of benefit cessation.

For the WOTC credit, eligible wages include only cash wages. For the WTW credit, eligible wages include amounts paid by the employer for: (1) educational assistance excludable under a section 127 program; (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

Membership in most WOTC and WTW target groups requires eligible persons to be members of families that benefit from means-tested government programs, to live in areas with high poverty rates, or to have participated in government programs that provide benefits to handicapped workers. However, ex-felons are required to be members of families which have incomes for a specified 6-month period that, when annualized, do not exceed 70 percent of the Lower Living

Standard published by the Bureau of Labor Statistics. State employment security agencies (SESAs) are responsible for certifying that individuals are eligible for the credits.

Many workers eligible for the WTW credit are also eligible for WOTC. Employers of such workers may claim either the WOTC or WTW credit, but not both, in any taxable year. The WOTC and WTW credits are effective for workers hired before January 1, 2006. The Katrina Emergency Tax Relief Act of 2005 expanded WOTC eligibility to Hurricane Katrina employees and waived the usual certification requirements for those employees. A Hurricane Katrina employee is defined as a person with a principal place of abode in the core disaster area on August 28, 2005, and who is:

- hired during the two-year period beginning on such date if the principal place of employment for the new position is located in the core disaster area; or

- is displaced by Hurricane Katrina and hired during the period beginning August 28, 2005, and ending on December 31, 2005 (regardless of the location of the new position).

Reasons for Change

The WOTC and WTW credits provide tax incentives to employers for hiring economically disadvantaged workers, but the rules for computing the credits differ in ways that are hard to justify. Employers of WTW-eligible long-term welfare recipients, who generally are more costly to employ than WOTC workers, receive lower credits in the initial phase of employment than employers of WOTC workers. Because many WTW employees are also eligible for WOTC, employers of these workers compute credits under both sets of rules to determine which credit is more advantageous. To compute WTW credits, employers have to calculate the value of certain fringe benefits paid to each WTW worker hired, which is difficult and costly relative to the expected tax benefits. The family-income test for the WOTC credit's ex-felon target group is burdensome for administrative agencies and reduces employer incentives for hiring ex-felons.

Proposal

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 requirement 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. The proposal would not change the current law WOTC eligibility of Hurricane Katrina Employees.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-80	-144	-86	-25	-7	-3	-265	-266

FIRST-TIME HOMEBUYER CREDIT FOR THE DISTRICT OF COLUMBIA

Current Law

A one-time, nonrefundable $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.

Reasons for Change

The homeownership rate in the District of Columbia is significantly below the rate for neighboring states and the nation as a whole. Homeownership fosters healthy, vibrant communities and is a key to revitalizing the Nation's capital. Extending the credit would enhance the District's ability to attract new homeowners and establish a stable residential base.

Proposal

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.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-1	-18	--	--	--	--	-18	-18

AUTHORITY TO ISSUE QUALIFIED ZONE ACADEMY BONDS

Current Law

Under current law, state and local governments can issue qualified zone academy bonds (QZABs) to fund the improvement of certain eligible public schools. An eligible holder of a QZAB receives annual federal income tax credits. These annual credits compensate the holder for lending money and, therefore, are treated like taxable interest payments for federal tax purposes. Eligible holders are banks, insurance companies, and corporations actively engaged in the business of lending money. The credit rate for a QZAB is set on its day of sale by reference to credit rates established by the Department of the Treasury. The maximum term of a QZAB is determined by reference to the adjusted applicable federal rate (AFR) published by the Internal Revenue Service. The higher the AFR, the shorter the maximum term (rounded to whole years) so as to keep the extent of the federal subsidy approximately equal to half the face amount of the bond.

Current law establishes authority to issue $400 million of QZABs for each year from 1998 through 2005. The annual cap is allocated among the states in proportion to their respective populations of individuals with incomes below the poverty line. Unused authority to issue QZABs may be carried forward for two years (three years for authority arising in 1998 and 1999) after the year for which the authority was established.

A number of requirements must be met for a bond to be treated as a QZAB. First, the bond must be issued pursuant to an allocation of bond authority from the issuer's state educational agency. Second, at least 95 percent of the bond proceeds must be used for an eligible purpose at a qualified zone academy. Eligible purposes include rehabilitating school facilities, acquiring equipment, developing course materials, or training teachers. A qualified zone academy is a public school (or an academic program within a public school) that is designed in cooperation with business and is either (1) located in an empowerment zone or enterprise community, or (2) attended by students at least 35 percent of whom are estimated to be eligible for free or reduced-cost lunches under the National School Lunch Act. Third, private entities must have promised to contribute to the qualified zone academy certain property or services with a present value equal to at least 10 percent of the bond proceeds. There is no requirement that issuers of QZABs report issuance to the Internal Revenue Service (IRS). Issuers of tax-exempt bonds must report issuance to the IRS by filing information returns.

Reasons for Change

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.

Proposal

The authority to issue $400 million of QZABs per year would be extended for one year to 2006. For QZABs issued after the 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.

Revenue Estimate

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
-3	-8	-13	-18	-20	-20	-79	-179

DISCLOSURE OF TAX RETURN INFORMATION RELATED TO TERRORIST ACTIVITY

Current Law

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). With respect to returns and return information that the taxpayer supplied (other than taxpayer identity information), the IRS cannot make the disclosure to federal law enforcement or intelligence agency officers and employees without a court order indicating there is reasonable cause to believe the returns and return information at issue are relevant to the terrorist incident, threat or activity. If a federal law enforcement or intelligence agency seeks returns or return information, specified officials in the Department of Justice may apply for an ex parte court order. If the IRS wishes to apprise a federal law enforcement agency of a terrorist incident, threat, or activity, the IRS may apply for an ex parte court order and may make disclosures to the Department of Justice as necessary to prepare such application on behalf of the IRS.

Reasons for Change

This disclosure authority relating to terrorist activities expires on December 31, 2006. The Administration believes that extension would help provide continued support for investigations and responses relating to terrorism.

Proposal

The Administration proposes to extend this authority until December 31, 2007.

Revenue Estimate

[No revenue effect]

DISCLOSURE OF TAX RETURN INFORMATION FOR ADMINISTRATION OF STUDENT AID

Current Law

The IRS may disclose a taxpayer's filing status, adjusted gross income, and identity information to the Education Department (ED) – but not to ED contractors – only for purposes of establishing income contingent repayment amounts for certain student loans. This provision is scheduled to expire on December 31, 2006.

Reasons for Change

ED's student financial aid application requires applicants (and their parents) to provide information on adjusted gross income, earnings from employment, income tax liability, and type of tax return filed. Financial aid applications are processed by ED contractors, but neither ED nor a contractor is permitted to receive return information from the IRS to verify the information on the financial aid applications. Allowing ED to use return information from the IRS to verify financial aid applications would significantly reduce fraud and error, allowing financial aid to be directed to those students who are truly in need. In particular, statistical studies indicate that Pell Grant overpayments could be reduced by hundreds of millions of dollars each year if this type of verification were permitted.

Proposal

The Administration's proposal would supplant the existing provision, permitting the IRS to disclose to ED and ED's 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. ED 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.

The proposal would apply to requests for disclosures made after the date of enactment.

Revenue Estimate

[No revenue effect]

EXCISE TAX ON COAL

Current Law

An excise tax is imposed on coal at a rate of $1.10 per ton for coal from underground mines and $0.55 per ton for coal from surface mines. In either case, the tax imposed with respect to a ton of coal may not exceed 4.4 percent of the amount for which it is sold by the producer. Receipts from the tax are deposited in the Black Lung Disability Trust Fund. Amounts in the Fund are used to pay compensation, medical, and survivor benefits to eligible miners and their survivors and to cover costs of program administration. Miners and survivors qualify for benefits from the Fund only if the miner's mine employment terminated before 1970 or no mine operator is liable for the payment of benefits. The Fund is also permitted to borrow from the general fund any amounts necessary to make authorized expenditures if excise tax receipts do not provide sufficient funding.

Reduced rates of tax apply after the earlier of December 31, 2013, or the date on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the general fund of the Treasury. The reduced rates of tax are $0.50 per ton for coal from underground mines and $0.25 per ton for coal from surface mines. In addition, the maximum tax imposed with respect to a ton of coal is reduced from 4.4 percent of the amount for which it is sold by the producer to 2 percent of that amount.

Reasons for Change

To reduce the duration of the general fund subsidy for black lung disability programs, excise tax rates on coal should remain at their current levels until all amounts borrowed from the general fund of the Treasury have been repaid with interest.

Proposal

The Administration's 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 $0.50 per ton for coal from underground mines and $0.25 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.

Revenue Estimate[26]

Fiscal Years							
2006	2007	2008	2009	2010	2011	2007-2011	2007-2016
($ in millions)							
--	--	--	--	--	--	--	750

[26] Net of income offsets

INCLUDE COMBAT PAY AS EARNED INCOME FOR EITC

Current Law

Subject to certain limitations, compensation earned by members of the Armed Forces while serving in combat zones may be excluded from gross income. Enlisted personnel and warrant officers may exclude the full amount of compensation earned in combat zones. Commissioned officers may also exclude compensation earned in combat zones, but only to the extent it does not exceed the maximum amount that enlisted personnel receive. For up to two years following service in a combat zone, military personnel may also exclude compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in a combat zone.

Nontaxable compensation is not includable in earned income for purposes of computing the earned income tax credit (EITC). However, a taxpayer may elect to treat combat pay otherwise excluded from gross income as earned income for purposes of the EITC, effective for taxable years ending after October 4, 2004, and before January 1, 2007.

Reasons for Change

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 a number of factors, including the taxpayer’s rank, number of years of service in the military, number of months in a combat zone, marital status, and number of children. The effects of the exclusion are most adverse among very low-ranking enlisted personnel who serve in combat zones for most or all of the tax year. However, in 2005, the exclusion likely increased the EITC for most military personnel.

Extending the availability of the election to include combat pay as earned income for purposes of the EITC would assist very low-ranking enlisted personnel who serve long periods in combat zones, without disadvantaging other military personnel also serving in combat zones.

Proposal

The Administration proposes to extend this provision through December 31, 2007.

Revenue Estimates */
FY 2007 Budget Proposals Affecting Receipts

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2007-16
	Fiscal Years (in millions of dollars)												
Make Permanent Certain Tax Relief Enacted in 2001 and 2003:													
Dividends tax rate structure	288	571	-1,329	-14,161	-537	-6,545	-14,954	-20,511	-22,051	-23,524	-25,009	-22,001	-128,050
Capital gains tax rate structure	0	0	0	-14,183	-5,519	-6,606	-8,023	-9,342	-9,884	-10,409	-10,965	-26,308	-74,931
Expensing for small business	0	0	-4,679	-6,498	-4,872	-3,853	-3,113	-2,630	-2,380	-2,280	-2,315	-19,902	-32,620
Marginal individual income tax rate reductions	0	0	0	0	0	-66,918	-104,568	-105,998	-107,783	-109,175	-111,519	-66,918	-605,961
Child tax credit 1/	0	0	0	0	0	-5,497	-32,340	-32,496	-32,624	-32,664	-32,879	-5,497	-168,500
Marriage penalty relief 2/	0	0	0	0	0	-4,597	-9,341	-8,785	-8,164	-7,366	-6,671	-4,597	-44,924
Education incentives	0	0	0	0	3	-1,098	-1,737	-1,842	-1,953	-2,069	-2,264	-1,095	-10,960
Repeal of estate and generation-skipping transfer taxes, and modification of gift taxes	-205	-1,102	-1,728	-2,181	-2,676	-23,758	-53,122	-56,853	-61,562	-65,757	-70,283	-31,445	-339,022
Modifications of pension plans	0	0	0	0	0	-346	-468	-487	-503	-519	-535	-346	-2,858
Other incentives for families and children	0	0	0	0	5	-170	-845	-840	-838	-836	-838	-165	-4,362
Total make permanent the tax relief enacted in 2001 and 2003	83	-531	-7,736	-37,023	-13,596	-119,388	-228,511	-239,784	-247,742	-254,599	-263,278	-178,274	-1,412,188
Tax Incentives:													
Simplify and encourage saving:													
Expand tax-free savings opportunities	0	4,796	10,407	7,507	3,970	-383	-4,321	-4,819	-5,281	-5,755	-6,243	26,297	-122
Consolidate employer-based savings accounts	0	0	-542	-579	-618	-1,826	-2,727	-2,948	-3,277	-3,607	-3,939	-3,565	-20,063
Establish Individual Development Accounts	0	0	-134	-286	-326	-300	-255	-216	-184	-65	3	-1,046	-1,763
Total simplify and encourage saving	0	4,796	9,731	6,642	3,026	-2,509	-7,303	-7,983	-8,742	-9,427	-10,179	21,686	-21,948
Encourage entrepreneurship and investment:													
Increase expensing for small business	0	-2,522	-3,527	-2,625	-2,037	-1,645	-1,398	-1,266	-1,214	-1,220	-1,259	-12,356	-18,713
Invest in health care:													
Expand health savings accounts (HSAs) 3/	---	-2,069	-4,499	-6,454	-8,030	-9,178	-10,131	-11,053	-12,024	-13,078	-14,196	-30,230	-90,712
Provide a refundable tax credit for the purchase of high-deductible health insurance 4/	---	-635	-1,608	-2,289	-2,653	-2,705	-2,747	-2,788	-2,845	-2,890	-2,933	-9,890	-24,093
Provide an above-the-line deduction and payroll tax credit for the purchase of high-deductible health insurance 5/	---	-2,763	-4,130	-4,159	-3,994	-3,973	-4,125	-4,290	-4,450	-4,620	-4,823	-19,019	-41,327
Improve the Health Coverage Tax Credit 6/	---	-5	-13	-16	-19	-20	-21	-22	-23	-25	-26	-73	-190
Allow the orphan drug tax credit for certain pre-designation expenses	---	0	0	0	0	0	0	0	0	0	0	0	0
Total invest in health care	---	-5,472	-10,250	-12,918	-14,696	-15,876	-17,024	-18,153	-19,342	-20,613	-21,978	-59,212	-156,322
Provide incentives for charitable giving:													
Permit tax-free withdrawals from IRAs for charitable contributions	0	-102	-510	-512	-501	-497	-500	-509	-519	-523	-533	-2,122	-4,706
Expand and increase the enhanced charitable deduction for contributions of food inventory	0	-44	-96	-106	-116	-127	-140	-154	-169	-187	-206	-489	-1,345
Reform excise tax based on investment income of private foundations	0	-56	-85	-90	-96	-102	-109	-118	-129	-140	-149	-429	-1,074
Modify tax on unrelated business taxable income of charitable remainder trusts	0	-1	-6	-6	-6	-6	-7	-7	-7	-8	-8	-25	-62
Modify basis adjustment to stock of S corporations contributing appreciated property	0	-3	-15	-21	-25	-28	-32	-37	-42	-47	-51	-92	-301
Repeal the $150 million limitation on qualified 501(c)(3) bonds	0	-2	-3	-6	-10	-11	-10	-10	-10	-10	-9	-32	-81
Repeal certain restrictions on the use of qualified 501(c)(3) bonds for residential rental property	0	-2	-5	-9	-16	-24	-31	-38	-44	-51	-58	-56	-278
Total provide incentives for charitable giving	0	-210	-720	-750	-770	-795	-829	-873	-920	-966	-1,014	-3,245	-7,847
Strengthen education:													

Revenue Estimates */
FY 2007 Budget Proposals Affecting Receipts

	Fiscal Years 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2007-16
	(in millions of dollars)												
Extend the above-the-line deduction for qualified out-of-pocket classroom expenses..............................	-17	-171	-178	-180	-183	-185	-188	-191	-194	-197	-200	-897	-1,867
Provide assistance to distressed areas:													
Establish Opportunity Zones...	0	-221	-411	-439	-451	-482	-517	-547	-584	-628	-680	-2,004	-4,960
Protect the environment:													
Extend permanently expensing of brownfields remediation costs..	-98	-146	-163	-177	-168	-157	-147	-140	-138	-136	-131	-811	-1,503
Restructure assistance to New York City:													
Provide tax incentives for transportation infrastructure....	0	-200	-200	-200	-200	-200	-200	-200	-200	-200	-200	-1,000	-2,000
Repeal certain New York City Liberty Zone incentives ...	0	200	200	200	200	200	200	200	200	200	200	1,000	2,000
Total restructure assistance to New York City	0	0	0	0	0	0	0	0	0	0	0	0	0
Total tax incentives..	-115	-3,946	-5,518	-10,447	-15,279	-21,649	-27,406	-29,153	-31,134	-33,187	-35,441	-56,839	-213,160
Simplify the Tax Laws for Families:													
Clarify uniform definition of a child 7/..................................	0	17	236	246	282	282	260	285	314	338	359	1,063	2,619
Simplify EITC eligibility requirement regarding filing status, presence of children, and work and immigrant status 8/..	0	215	-147	-123	-122	-123	-122	-120	-118	-117	-117	-300	-894
Reduce computational complexity of refundable child tax credit 9/..		0	332	342	347	357	362	371	376	380	396	1,378	3,263
Total simplify the tax laws for families......................	0	232	421	465	507	516	500	536	572	601	638	2,141	4,988
Strengthen the Employer Based Pension System:													
Ensure fair treatment of older workers in cash balance conversions and protect defined benefit plans................	3	53	62	77	89	100	111	121	132	142	152	381	1,039
Strengthen funding for single-employer pension plans........	0	536	2,290	-153	-2,336	-1,611	-1,391	-1,501	-1,561	-1,627	-1,826	-1,274	-9,180
Reflect market interest rates in lump sum payments...........	0	0	-3	-9	-17	-24	-30	-37	-44	-52	-58	-53	-274
Total strengthen the employer-based pension system....	3	589	2,349	-85	-2,264	-1,535	-1,310	-1,417	-1,473	-1,537	-1,732	-946	-8,415
Close Loopholes and Improve Tax Compliance:													
Combat abusive foreign tax credit transactions..............	0	1	2	2	3	3	3	3	3	3	3	11	26
Modify the active trade or business test..........................	0	6	8	8	8	8	9	10	10	11	11	38	89
Impose penalties on charities that fail to enforce conservation easements...	0	3	8	8	9	9	10	10	11	11	12	37	91
Eliminate the special exclusion from unrelated business taxable income for gain or loss on the sale or exchange of certain brownfields	0	2	14	30	43	41	33	23	12	3	0	130	201
Limit related party interest deductions.............................	0	82	141	148	155	163	171	180	189	198	208	689	1,635
Clarify and simplify qualified tuition programs.................	0	4	12	13	14	20	26	30	33	34	36	63	222
Total close loopholes and improve tax compliance..	0	98	185	209	232	244	252	256	258	260	270	968	2,264
Tax Administration, Unemployment Insurance, and Other:													
Improve tax administration:													
Implement IRS administrative reforms and initiate cost saving measures..	0	0	0	0	0	0	0	0	0	0	0	0	0
Reduce the tax gap													
Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes..................	0	3	5	5	5	6	6	6	7	7	7	24	57
Increase information reporting on payment													

Revenue Estimates */
FY 2007 Budget Proposals Affecting Receipts

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-11	2007-16
	Fiscal Years (in millions of dollars)												
card transactions...	0	9	20	20	21	22	24	25	27	28	29	92	225
Require increased information reporting for certain government payments for goods and services..	0	84	172	181	190	201	211	223	233	246	259	828	2,000
Amend collection due process procedures for employment tax liabilities...............................	0	140	86	33	16	14	14	14	15	16	16	289	364
Expand the signature requirement and penalty provisions applicable to paid tax return preparers……………………………………………	0	23	68	72	64	65	113	117	124	131	137	292	914
Total reduce the tax gap......................................	0	259	351	311	296	308	368	385	406	428	448	1,525	3,560
Total improve tax administration.................................	0	259	351	311	296	308	368	385	406	428	448	1,525	3,560
Strengthen financial integrity of unemployment insurance:													
Strengthen the financial integrity of the unemployment insurance system by reducing improper benefit payments and tax avoidance 10/.....................	0	0	31	30	-106	-143	-538	-211	-518	-299	-492	-188	-2,246
Extend unemployment insurance surtax 10/..................	0	0	1,085	1,490	1,526	1,564	1,602	340	-1,461	-2,913	-2,523	5,665	710
Total strengthen financial integrity of unemployment insurance....................................	0	0	1,116	1,520	1,420	1,421	1,064	129	-1,979	-3,212	-3,015	5,477	-1,536
Other proposals:													
Increase Indian gaming activity fees...............................	0	0	5	5	5	5	5	5	5	5	5	20	45
Total tax administration, unemployment insurance, and other..	0	259	1,472	1,836	1,721	1,734	1,437	519	-1,568	-2,779	-2,562	7,022	2,069
Modify Energy Policy Act of 2005:													
Repeal reduced recovery period for natural gas distribution lines...	0	12	44	80	112	125	111	92	83	84	90	373	833
Modify amortization for certain geological and geophysical expenditures..	0	38	140	206	169	88	30	14	15	15	15	641	730
Total modify Energy Policy Act of 2005.......................	0	50	184	286	281	213	141	106	98	99	105	1,014	1,563
Promote Trade:													
Implement free trade agreements.......................................	0	-236	-456	-593	-741	-832	-900	-978	-1,062	-1,153	-1,249	-2,858	-8,200
Extend GSP...	0	-412	-617	-666	-723	-786	-241	0	0	0	0	-3,204	-3,445
Total promote trade...	0	-648	-1,073	-1,259	-1,464	-1,618	-1,141	-978	-1,062	-1,153	-1,249	-6,062	-11,645
Extend Expiring Provisions:													
Minimum tax relief for individuals......................................	-13,664	-20,495	---	---	---	---	---	---	---	---	---	-20,495	-20,495
Research & Experimentation (R&E) tax credit..................	-2,097	-4,601	-5,944	-6,889	-7,669	-8,340	-9,015	-9,746	-10,535	-11,389	-12,312	-33,443	-86,440
Combined work opportunity/welfare-to-work tax credit...	-80	-144	-86	-25	-7	-3	-1	0	0	0	0	-265	-266
First-time homebuyer credit for the District of Columbia..	-1	-18	0	0	0	0	0	0	0	0	0	-18	-18
Authority to issue Qualified Zone Academy Bonds..	-3	-8	-13	-18	-20	-20	-20	-20	-20	-20	-20	-79	-179
Disclosure of tax return information related to terrorist activity..	0	0	0	0	0	0	0	0	0	0	0	0	0
Disclosure of tax return information for administration of student aid..	0	0	0	0	0	0	0	0	0	0	0	0	0
Excise tax on coal 10/...	0	0	0	0	0	0	0	0	192	277	281	0	750
Total extend expiring provisions..............................	-15,845	-25,266	-6,043	-6,932	-7,696	-8,363	-9,036	-9,766	-10,363	-11,132	-12,051	-54,300	-106,648

Revenue Estimates */
FY 2007 Budget Proposals Affecting Receipts

	Fiscal Years												
	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2007-11**	**2007-16**
	(in millions of dollars)												
Total budget proposals..	-15,874	-29,163	-15,759	-52,950	-37,558	-149,846	-265,074	-279,681	-292,414	-303,427	-315,300	-285,276	-1,741,172

*/ Estimates presented for certain provisions identified in the table include the effects of both receipts and outlays. For these provisions, estimates differ from those presented in Table 17-3 of the Analytical Perspectives of the President's Budget, which presents only the effect on receipts of the Administration's legislative proposals.

1/ Affects both receipts and outlays. The outlay effect is $45 million in 2011, $10,471 million in 2012, $10,396 million in 2013, $10,345 million in 2014, $10,237 million in 2015, $10,315 million in 2016, $45 million in 2007-2011 and $51,809 million in 2007-2016.
2/ Affects both receipts and outlays. The outlay effect is -$371 million in 2011, $1,582 million in 2012, $1,566 million in 2013, $1,545 million in 2014, $1,522 million in 2015, $1,502 million in 2016, -$371 million in 2007-2011 and $7,346 million in 2007-2016.
3/ Affects both receipts and outlays. The outlay effect is $91 million in 2007, $178 million in 2008, $253 million in 2009, $310 million in 2010, $352 million in 2011, $388 million in 2012, $423 million in 2013, $461 million in 2014, $501 million in 2015, $543 million in 2016, $1,184 million in 2007-2011 and $3,500 million in 2007-2016.
4/ Affects both receipts and outlays. The outlay effect is $381 million in 2007, $747 million in 2008, $1,095 million in 2009, $1,249 million in 2010, $1,343 million in 2011, $1,429 million in 2012, $1,524 million in 2013, $1,627 million in 2014, $1,721 million in 2015, $1,823 million in 2016, $4,815 million in 2007-2011 and $12,939 million in 2007-2016.
5/ Affects both receipts and outlays. The outlay effect is $244 million in 2007, $315 million in 2008, $319 million in 2009, $303 million in 2010, $305 million in 2011, $317 million in 2012, $330 million in 2013, $341 million in 2014, $355 million in 2015, $371 million in 2016, $1,486 million in 2007-2011 and $3,200 million in 2007-2016.
6/ Affects both receipts and outlays. The outlay effect is $4 million in 2007, $10 million in 2008, $12 million in 2009, $14 million in 2010, $15 million in 2011, $15 million in 2012, $16 million in 2013, $17 million in 2014, $18 million in 2015, $18 million in 2016, $55 million in 2007-2011 and $139 million in 2007-2016.
7/ Affects both receipts and outlays. The outlay effect is -$170 million in 2008, -$196 million in 2009, -$250 million in 2010, -$234 million in 2011, -$230 million in 2012, -$253 million in 2013, -$277 million in 2014, -$298 million in 2015, -$316 million in 2016, -$850 million in 2007-2011 and -$2,224 million in 2007-2016.
8/ Affects both receipts and outlays. The outlay effect is -$188 million in 2007, $123 million in 2008, $102 million in 2009, $96 million in 2010, $95 million in 2011, $100 million in 2012, $95 million in 2013, $91 million in 2014, $87 million in 2015, $86 million in 2016, $228 million in 2007-2011 and $687 million in 2007-2016.
9/ Affects only outlays. The outlay effect is -$332 million in 2008, -$342 million in 2009, -$347 million in 2010, -$357 million in 2011, -$362 million in 2012, -$371 million in 2013, -$376 million in 2014, -$380 million in 2015, -$396 million in 2016, -$1,378 million in 2007-2011 and -$3,263 million in 2007-2016.
10/ Net of income offsets.

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